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Comments and Recommendations Regarding H.R. 8363, the Revenue Act of 1963

American Institute of Certified Public Accountants. Committee on Federal Taxation

COMMITTEE ON FEDERAL TAXATION

of the

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

COMMENTS AND RECOMMENDATIONS

REGARDING H.R. 8363
THE REVENUE ACT OF 1963

PRESENTED TO THE COMMITTEE ON FINANCE

SENATE OF THE UNITED STATES

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INTRODUCTION

The comments, recommendations and observations on H.R. 8363 and certain of its amendments contained in this statement represent the opinion of the committee on federal taxation of the American Institute of Certified Public Accountants.

The American Institute of Certified Public Accountants is the sole national organization of professional CPAs in this country. It has over 47,000 members. Its 66 member committee on federal taxation has been authorized by the Institute's governing Council to speak on its behalf in matters related to federal taxation. The committee is carefully chosen to provide representation from all parts of the country, from all sizes of professional CPA firms, and from firms rendering professional services to all kinds of industrial and other organizations, both large and small.

This statement is divided into three parts:

I. General conclusions on H.R. 8363.

II. Recommendations on provisions and amendments of H.R. 8363 of particular interest.

III. Technical comments on specific provisions of H.R. 8363.

PART I

GENERAL CONCLUSIONS ON H.R. 8363

<u>GENERAL CONCLUSIONS ON H.R. 8363</u>

OBJECTIVE AND SCOPE OF H.R. 8363

During the period prior to the hearings that led to the introduction of H.R. 8363 by the Committee on Ways and Means, general agreement had been reached among representatives of all segments of the country's economy-government, business, labor, and consumers-on the importance of tax revision and reform as a means of stimulating economic growth. It was in reflection of this general agreement that President John F. Kennedy, on January 24, 1963, sent to Congress his proposals for tax changes intended to strengthen the vigor of our economy, increase job and investment opportunities, increase incentives to risk taking, and increase productivity. Our committee agrees with the importance of these general objectives. We agree also that an appropriate revision of tax rates would do a great deal to achieve them.

As certified public accountants serving taxpayers in many industries and in many parts of the country, we are well aware of the restrictive and inhibiting effects of the present tax law upon our business economy. This negative force has four principal aspects:

(1) The overly rapid progression of income tax rates to an excessively high level reduces incentives and initiative and limits internal generation of the funds necessary to growth.

(2) Unwarranted benefits made available to some taxpayers or seized by others through careful planning have a tendency, while rewarding those who obtain them, to cause the tax laws to bear even more heavily on others who do not enjoy them.

(3) The influence of tax provisions on business decisions may be so great that it becomes advantageous to set aside normal and sound business considerations when faced with the overwhelming importance of tax results.

(4) Complexities of the law, which have increased at an accelerated pace in recent years, demand too much of the time and abilities that should be devoted to more productive pursuits. The worth of any major tax revision should be measured by the extent to which it solves these problems and by whether, in fact, it may add to them instead of providing solutions.

In addition, tax legislation should meet equally important standards of fiscal policy, such as avoidance of the inflationary thrust that could come from a succession of seriously unbalanced budgets. In the light of a budget already out of balance, we believe that every effort should be made to hold expenditures to reasonable levels while the stimulative action of proposed tax reduction has a chance to take effect. With a substantial deficit in prospect, it seems especially important that rates should be reduced only in a way best designed to advance the economic growth of the country.

GENERAL ACCEPTABILITY OF RATE REDUCTIONS

If the provisions of H.R. 8363 for rate reductions and revision are modified to reflect several major recommendations which we will present in these comments, we believe the changes should be adopted.

Although we recognize the importance of both the stimulation of consumption and the provision of increased incentives for productive investment, we question whether the proposed changes allocate enough of the planned revenue reduction to those taxpayer groups best able to advance economic growth through the investment of funds and through their response to the incentives of more reasonable rates. The provisions of H.R. 8363 seem, on balance, to provide disproportionate relief at the income levels where stimulation of consumption would result.

We suggest that the following changes would be desirable:

(1) Provide a degree of tax rate relief in the middle income brackets at least equal to that proposed for those who pay taxes at the lowest rates. A disproportionate reduction in the bottom brackets does not seem warranted in the light of other provisions (such as the provisions for a minimum standard deduction and for liberalization of the child care deduction) that would provide additional relief to low income taxpayers at the cost of further narrowing of the tax base.

Even in the revised rate structures of H.R. 8363, the progression of tax rates is particularly inhibiting in the middle brackets. At the very least the degree of change should be no less in those brackets than in the lower brackets, thus strengthening needed incentives.

This is not inconsistent with reduction of the highest individual tax rates in an even greater degree. The additional reduction in the highest brackets would have a small revenue impact and it would remove the worst feature of the present rate structure, which tends to eliminate income-producing incentives for the most successful.

(2) The proposal to reduce normal tax rates for corporations by eight percentage points while reducing the general corporate rate by only four percentage points seems unwarranted. It would result in sharper progression in the rate structure than at present.

We suggest limiting the reduction in the normal tax rate to four percentage points, the same change as is proposed for the general corporate rate. This would provide a reduction of 13.3 percent in the taxes of corporations with taxable incomes of $25,000 per year or less, as compared with a reduction of 7.7 percent for large corporations and a reduction of 26.7 if the eight point reduction in the normal rate were adopted.

(3) There should be sufficient modification of the planned acceleration in corporate tax payments to permit affected corporations to retain some of the benefits of the tax rate reductions proposed for them. The acceleration of payments during the years 1964 through 1970 would result in some corporations paying more taxes during some of those years than they would pay without the enactment of H.R. 8363.

Although information developed by the Staff of the Joint Committee on Internal Revenue Taxation indicates that corporations would not actually pay more tax if their estimates were based on 75 percent of the tax above $100,000, in many instances this basis for estimating will not provide adequate protection against penalties because of the uncertainties of attempting to determine income at interim periods, especially early in a year. As is indicated in the Staff study, if current payments were based on 100 percent of the tax above $100,000, some corporations would make greater payments in 1966, 1967 and 1968 than in 1963.

There are other problems in the proposed acceleration of corporate payments. The requirement of an initial estimate by April 15 for a calendar year corporation would mean that many would have to base their computations on operations for the first two months of the year, since they might require more than 15 days to close their books and prepare the necessary data for the initial 3-month period. This could mean that the April 15th estimates would be relatively meaningless. Two months of operations may not provide an adequate basis of prediction because of fluctuations in income and the difficulty of identifying trends in operations based upon such a short period. The available procedure for obtaining refunds of overpayments would not solve this problem. The probable excesses may not relate to anticipated total payments for the year, but only to a proportionate part of 70 percent thereof, which is the basis for estimating. In addition, the procedure for making refunds would not operate rapidly enough to provide immediate relief.

Some corporations would not have funds available to meet the accelerated payments and in some cases they may have difficulty in raising the necessary funds. In any event some of the payments would be made from amounts that otherwise might be available for business expansion. Thus, acceleration would tend to defeat the objective of providing greater incentives for investment.

We suggest that corporate estimated payments be made in equal amounts of one-third, with the first payment in the sixth month of the taxable year and the second and third payments in the ninth and twelfth months. This would reduce the drain on corporate funds and would ease the problem of estimating at a time too early in the taxable year to determine what the income of the year may be.

STRUCTURAL REVISIONS OF PARTICULAR INTEREST

In Part II of these comments we present our recommendations on those sections of H.R. 8363 and those proposed amendments which appear to us to be particularly worthy of your favorable action because they would improve the structure of the tax law, significantly remove serious inequities, or contribute substantially to simplification. They are:

1. Section 202(a) - Simplification of investment credit.
2. Section 221 - Income averaging.
3. Section 222 - Consolidated returns and intercorporate dividends.
4. Amendment 229 - Entertainment, travel and gift expenses.
5. Amendment 319 - Depreciation guidelines.

OTHER STRUCTURAL REVISIONS

Although the planned rate reductions would, with the modifications we have suggested, represent a substantial and worthwhile response to general dissatisfaction with high tax rates, the remainder of the revisions, considered as a whole, do not meet adequately the very pressing need for reform in the structure of our tax system. Some provisions of H.R. 8363 would terminate special benefits available for some taxpayers, but other provisions would extend special benefits, and in some instances the bill would have the effect of terminating special benefits for taxpayers at one income level while retaining similar benefits for other taxpayers. While some of the structural revisions represent improvements, they do not even approach a redistribution of the inequitable burdens of the tax system or the problem of the weight that must be accorded the system in developing plans for business operations and designing the form of business transactions.

Of even greater concern to our committee is the fact that the bill not only would make no real move in the direction of simplification of the Code but would actually add a great deal to its complexity. It would continue the trend of recent years of adding a multiplicity of detailed provisions to the law.

We believe some of the proposed changes should be deferred for further study and for further consideration of the extent to which they should be carried in developing solutions to the problems to which they are directed. There is a further question with respect to several of the provisions as to whether the improvements achieved and the revenue recovered are sufficiently significant to justify the further compounding of complexities.

We suggest, therefore, that no action be taken on the following provisions pending further study of the need for them and of the possibility of making them less complex:

1. <u>Group Term Life Insurance Purchased for Employees</u> - The proposed change in the treatment of group term life insurance deals with only one small segment of the broad question of employee compensation and fringe benefits. We believe this change should be deferred until the whole area can be reviewed and a comprehensive plan developed

for any necessary revisions in the treatment of employee compensation. In addition, as is explained further in the comments in Part III, we question the advisability of two of the key features of Section 203. In view of these questions and the need for additional study, the estimated revenue of $5,000,000 that would be obtained from this revision does not seem to warrant its adoption at this time.

2. Interest on Certain Deferred Payments - The provisions of Section 215, which would require imputation of interest in connection with sales of property under deferred payment contracts, seems to be an attempt to fit all business transactions of this type within a pre-conceived idea as to what their nature might be. This additional complexity in the tax law does not seem warranted, either by the existing abuses or by the revenue effect, since it has been estimated that the revenue effect of the change would be negligible.

The added complexities would be particularly unfortunate because they would affect many taxpayers, including taxpayers who do not engage in business. The necessity placed upon these taxpayers of determining "unstated interest," which in turn requires the computation of present values of installment payments, means that they would be faced with problems they are not equipped to handle, thus being forced to seek professional assistance with what otherwise might be relatively simple tax returns.

The mere absence of a stated interest element in a deferred payment transaction does not necessarily mean that the buyer and seller are conniving to avoid the passage of ordinary income. These arrangements usually are determined at arm's length. It seems just as incorrect to impute interest where interest is not actually intended, which is the effect of Section 215, as to fail to recognize an interest element that happens to be unstated by the contracting parties. In any event, if it is believed that there are serious abuses in the present pattern of transactions, a more reasonable solution would be to impute interest only in those types of situations where abuses are believed to exist.

In any event, it should be unnecessary to use a rate of interest for purposes of imputation that is any higher than the prime commercial short-term rate. This would avoid to some extent the complexities provided by the proposed provision.

3. Personal Holding Companies - We do not wish to disagree with any reasonable measures to further minimize the extent to which passive or investment income can be sheltered in closely held corporations in order to take advantage of the lower corporate tax rates. However, it does seem that the mere bulk and intricacy of the additional provisions of Section 216, which cover 44 pages in the bill passed by the House of Representatives, are sufficient in themselves to suggest that they require substantial further study before they are adopted.

Several of the proposed provisions should be reconsidered because they are overly restrictive, representing what appears to be an overreaction to the ills they would seek to cure. Others seem to add unnecessarily to the complexity of the personal holding company rules. While we have commented in Part III of these comments on those provisions to which we take particular exception, in view of its complexity we believe that all of Section 216 should be deferred for further study.

TECHNICAL COMMENTS ON SPECIFIC PROVISIONS

In addition to the preceding comments on the basic structural revisions of H.R. 8363, in the accompanying Part III of our comments we present suggestions for technical improvements in several of the provisions of the bill.

PART II

RECOMMENDATIONS ON PROVISIONS AND AMENDMENTS OF H.R. 8363 OF PARTICULAR INTEREST

Simplification of Investment Credit

Section 202 of H.R. 8363 would repeal the requirement that the basis of assets be reduced by the amount of the investment credit that arose as the result of their acquisition. We urge that this provision be approved by your committee.

The adoption of total cost as the basis for computating depreciation would permit realization of the full beneficial effect of the investment credit and would be welcomed by business taxpayers, large and small, as a major simplification in the accounting for machinery, equipment and similar assets. It would put an end to the burdensome complexities that result from the present provisions of the Codes.

A. Full beneficial effect of credit should be realized. -

Although the investment credit was adopted in 1962 to stimulate industrial expansion, and there is evidence that it was successful in encouraging investment, thus contributing to the satisfactory level of business operations during the past year, the structure of the credit provision is such that its stimulative force will be blocked more and more in the future by the action of the provision for reduction of the basis for depreciation.

The effect of the reduction of basis by the amount of the investment credit is that approximately one-half of the credit is recaptured by the Treasury over the life of the assets on which the credit is based. The basis reduction gives one-half of the investment credit the general status of an interest free loan from the Government, repayable over the life of the related assets. As additional investments are made each year in machinery and equipment, the amounts to be repaid (because of the basis adjustment) will grow larger and larger, with the result that the net amount realized from the credit on these future investments will diminish. Over the replacement cycle of the machinery and equipment of a business, the stimulative affect of the credit will gradually decrease and, when a full cycle has been completed, the credit will tend to be only 50% effective. Thus, the value of the investment credit as an economic stimulant will decline from year to year.

The repeal of the requirement that the cost of assets be reduced by the investment credit will permit the credit to exert the <u>full</u> beneficial effect upon the economy that was originally intended.

B. <u>Present law adds complicated and costly record-keeping burdens</u>. - The basis reduction requirement has caused substantial complications in the accounting for depreciable assets. The cost of maintaining the necessary additional records is believed by many taxpayers to offset practically all of the benefits of the investment credit. Had the credit been elective, many taxpayers would have rejected it rather than assume the additional record-keeping burdens.

The requirement that basis be reduced causes a number of differences between the books and the tax return in accounting for the assets. While these differences are not complicated as related to a single asset, the large number of assets used by most businesses causes a serious problem since, for all practical purposes, records must be maintained of both the book and tax basis of each asset. The following example shows the kinds of differences that arise:

	For Books	For Tax Return
Cost of asset purchased January 1, 1963	$ 3,000	$ 3,000
Investment credit applicable (expected to have 10 year life)		210
Basis For Computing Depreciation	$ 3,000	$ 2,790
Asset sold on January 1, 1969 for $1500 (6 years depreciation based on 10 year life)	1,800	1,674
Adjusted Basis Before Recapture	$1,200	$1,116
Restore 1/3 of investment credit because asset held only 6 years		70
Depreciated cost at date of sale	$ 1,200	$ 1,186
Sale price of asset	1,500	1,500
Depreciated cost	1,200	1,186
Profit on sale	$ 300	$ 314

The differences between the books and tax return in accounting for this asset are four:

1. For tax purposes the $210 investment credit is applied in reduction of the cost of the asset.
2. In each year the book depreciation is $300 as compared with tax depreciation of $279.
3. In the year of sale 1/3 of the investment credit is required to be restored to the tax basis.
4. The gain on sale of the asset is greater for tax purposes than is reflected on the books.

Even though the majority of taxpayers compute the provision for depreciation on a composite or group basis rather than on individual items, the differences set forth above must be considered under those methods when an asset is disposed of and the results of the disposition are recorded. Furthermore, the possibility that a part of the credit may have to be restored makes necessary the maintainence of records that permit the identification of assets retired prematurely.

At best, proper accounting for depreciable assets involves substantial time and expense because of the sheer number of assets used by most businesses. Differences, such as the ones illustrated, add to the time and cost of maintaining records.

A question might be raised as to why a business does not keep its depreciable asset records on the tax basis and eliminate these differences. Although some taxpayers may do so, many are subject to other conflicting accounting requirements which must be observed. For example, any company that is required to file annual statements with the Securities and Exchange Commission must report depreciable assets in its financial statements at full cost and not on a tax basis.

The depreciation guidelines released in 1962 by the Treasury Department (Rev. Proc. 62-21, 1962-2 CB 418) encourage some simplification of record-keeping for depreciable assets by establishing guideline lives which may be applied to composite or group asset accounts. Where composite or group accounts are employed for depreciation purposes, no identification of individual assets is required; however, identification of the cost of individual assets becomes necessary in accounting for the investment credit. Thus, the two procedures tend to work at cross purposes.

Additional accounting complications arise in the computation of allowable depreciation for state income tax purposes. The taxpayer will be required to disregard the investment credit adjustment to basis where no similar basis adjustment is applicable under state law. To meet this problem a separate set of depreciation records may be necessary, adding to the record-keeping burdens.

There are still other complications. Lessees of property must keep detailed records in order to adjust their rent deductions. "Conduit" entities, such as partnerships or Subchapter S corporations, have particularly bothersome problems as a result of actions by their taxpaying participants; e.g., application of the limitation on the credit available for used property where an individual taxpayer belongs to more than one partnership.

INCOME AVERAGING

A plan for averaging income would provide much-needed fair treatment for those whose incomes fluctuate widely from year to year. For a number of years we have advocated an averaging plan of general application to replace the limited averaging provisions available under present law. Income averaging is essential to do justice to taxpayers subject to wide fluctuations of income, particularly where they have only a few years of peak earnings. Accordingly, we welcome in principle the plan contained in H.R. 8363 and we recommend its adoption.

We have reservations, however, as to the adequacy of the plan contained in proposed Section 221. It is so restrictive that it would not provide effective relief in many situations where relief should be granted. We urge as an alternative a plan that would permit averaging over selected blocks of five years with no one year being included in more than one block of five.

A. Plan proposed in Section 221 is deficient - The proposed averaging provisions would require that taxable income for the current year exceed 133-1/3 percent of average taxable income for the prior four years and that the excess amount subject to averaging exceed $3,000. Although the $3,000 floor would help to avoid unimportant adjustments, the limitation of income subject to adjustment to that which exceeds 133-1/3 percent of the prior year's average tends to reduce the availability of relief. We grant that some exclusion is desirable to avoid refunds from minor fluctuations in income, but it would seem that a 5 percent exclusion would be sufficient when coupled with a floor of $3,000.

A more serious flaw in the plan is its failure to provide a device that would permit averaging over a period of years that extends beyond the years in which peak earnings are achieved. Some relief would be given in the first few years of peak earnings but none would be available if later years were followed by a substantial decline in earnings. This is because the year in which relief is to be granted would always be compared with past years. We feel that this defect would be overcome in a plan that we have recommended in the past, which would permit taxpayers to average over selected blocks of five years with no one year included in more than one block of five.

B. Recommended substitute for proposed plan - The plan for averaging which we recommend contains the following features:

1. A five-year block system of averaging made available, on an optional basis, to individual taxpayers, giving a taxpayer the privilege of using this system at intervals of five years or more. Once a particular year was included in a block it would not be included in a subsequent block. This system would make relief available to taxpayers whose incomes have declined.

2. The taxpayer would use the averaging system to determine the excess of the tax payable on the income of the most recent five years over the amount that would have been payable had one-fifth of that income been reported in each year. This would be done by totaling the taxable income for the five years, dividing the total by five, applying to the average income a tax at average rates, multiplying the average tax figures by five, and finally, comparing that total with the total tax actually paid for the five years. The use of average rates (which, based on a special formula to be set forth in the Code, would be prescribed and kept up to date by the Internal Revenue Service) in computing the tax on average income would avoid any

difficulty that might arise because of a change of tax rates during an averaging period. When a change in marital or other tax-significant status occurred during the averaging block, the five-year span would be divided into shorter averaging periods.

3. The excess of the tax paid over the total average tax as computed above would be refundable to the taxpayer only to the extent that it exceeded one percent of the total taxable income for the five-year period, or approximately 5 percent of the average for the period. This would introduce a tolerance factor which would limit the formula's use to taxpayers who would otherwise suffer severe hardships because of variations in annual income. Legislatively, this tolerance factor could be varied, making it higher or lower than the one suggested.

4. Administratively, the taxpayer could be required to file his averaging schedule with the tax return for the last year in the five-year block selected by him, so that the refund could be applied against the tax due from him for the final year in the block computed in the regular manner. Any excess could be made subject to the same election as to refund or application against estimated tax as is presently called for in the case of overpayments due to excess withholding or estimated tax payments. This system limits the number of tax adjustment claims and also prevents the use of low income years in more than one average.

C. Comparison of both plans. A comparison of the two methods for providing equitable results from income averaging indicates that proposed Section 221 is far more complex than the five-year block system. If income averaging should be designed to treat everyone as nearly equally for tax purposes as possible, without regard to the type of income involved, and at the same time take a form which is workable, the five-year block system should be more acceptable than the proposed provisions of Section 221.

The five-year block system requires no differentiation as to sources of income; it does not burden the Internal Revenue Service administratively, since it contains a tolerance factor; and averaging can be elected only once by a taxpayer in a five-year period. The block system also gives consideration to decreases in income which may occur in future years, making relief available to taxpayers whose incomes have declined, while the provisions of proposed Section 221 relieve only those whose incomes are increasing.

Furthermore, the five-year block system logically compares an average of income over a period of five years with the taxes paid applicable to such income for the same period of years. The averaging resulting from the income and tax comparison would seem to be more equitable than the averaging of income only, as is proposed by the provisions of Section 221.

D. Technical improvements in Section 221 - Several suggestions for improvements in the structure of Section 221 and for the elimination of some of its complexities are presented in Part III of these comments.

CONSOLIDATED RETURNS AND INTERCORPORATE DIVIDENDS

A. Eliminate 2% penalty on consolidated returns - The effect of Section 222 of H.R. 8363, providing for repeal of the 2% penalty tax on consolidated returns, would be to encourage the filing of consolidated returns by qualified affiliated groups of corporations.

We support this proposal because we believe that consolidating the results of operations of a group of commonly controlled corporations into a single economic unit for tax purposes may result in reflecting taxable income of such a group more clearly. A penalty tax should not be asserted if taxpayers choose to file consolidated returns as a more accurate measure of income.

Regardless of whether it is decided to enact Section 223 (relating to separate $25,000 surtax exemptions of a controlled group) the 2% penalty tax is not justified, since under existing law the individual surtax exemptions are waived where a consolidated return is filed. In effect, the affiliated group is treated as if it were a single corporation conducting operations through divisions, rather than through separate corporations. In a divisional situation no penalty tax would be exacted.

The filing of a consolidated return does permit losses of one or more members of the affiliated group to be offset against profits of other members of the group. It also permits tax-free payments of intercorporate dividends. However, this encourages a free flow of funds from one business operation to another, just as if the separate operations were conducted by divisions of one corporation. The alleged tax benefit from permitting the losses of one or more members to offset the profits of other members may not, in fact, exist. The regulations provide for a reduction in the basis of the stock or obligations of a loss corporation (in the hands of an affiliated corporation holding such stock) to the extent of losses availed of during a consolidated return period.

B. Intercorporate dividends should be free of tax - In addition to supporting enactment of Section 222, we recommend passage of legislation eliminating the tax on intercorporate dividends paid by members of an affiliated group of corporations, even though a consolidated return is not filed, to further harmonize the treatment of affiliated groups of corporations.

If the affiliated group elects not to file a consolidated return and elects instead under the provisions of Section 223 of H.R. 8363 to allocate one surtax exemption among the members of the group, the group should be permitted to transfer capital freely among its members as in the case of a single corporation operating through divisions and as in the case of an affiliated group filing a consolidated return.

There are many sound business reasons why some affiliated groups of corporations would not wish to file a consolidated return:

1. Where there are minority interests in a subsidiary company (which can be as much as 20%), filing a consolidated return could result in damage to the minority through diversion of tax benefits of that particular subsidiary to other companies in the affiliated group.

2. Various members of the group may be using alternative, but acceptable, tax accounting methods, but if they participate in a consolidated return they will be able to continue to use those differing methods only if the Commissioner consents (Regulations Section 1.1502-44).

3. The various members of the group may also be using different taxable years to conform with the natural business years of the separate enterprises. If they join in a consolidated return, all of them will be required to adopt the year of the parent, which may present business problems and in some cases may be impossible.

None of these reasons justify different treatment for affiliated groups which fail to file a consolidated return.

Entertainment, Travel and Gift Expenses

Because of substantial difficulties of interpretation, application and administration of Section 274, major modifications should be adopted. The proposed amendment to H. R. 8363, introduced by Senator Long on October 15th (Amendment No. 229), would accomplish the much needed revisions in a way which we support wholeheartedly.

The committee on federal taxation is opposed to entertainment expense abuses, as it is opposed to any misuses of the tax law. However, while the prevention of such abuses is the main purpose of Section 274 that is not its sole effect.

We are convinced that Section 274, in its present state, has the effect of disallowing many entertainment expense deductions which are perfectly proper, are dictated by sound business judgment, and result from a desire to maintain good relations with present customers and to foster amicable relations with prospective customers. On the other hand, Amendment No. 229 would have the desired effect of ending abuses without interfering with legitimate deductions.

In reassessing the problems in this area, there are several factors which should be considered in determining whether the suggested changes in Section 274 are warranted:

A. Reversal of Cohan rule appropriate - The statutory reversal of the Cohan rule was quite proper. Deductions are a matter of legislative grace, and it is not at all unreasonable to insist that taxpayers prove that an expense was incurred and that it fits the requirements of the section pursuant to which a deduction is sought.

B. Improved administration effective - A large part of the problem stems from inadequate and ineffective past administration of the law with respect to entertainment and travel expense deductions. While the law should be adequate from an administrative viewpoint, it should not be so stringently drawn as to overcompensate for past administrative failures. The experience of our members in the past year or so has indicated that the stepped-up activity of the Internal Revenue Service in obtaining more detailed information from taxpayers, in improving audit activities in connection with entertainment and travel expense deductions, and in developing more cases against deficient, negligent and fraudulent taxpayers, has been substantially better and more successful that in prior years.

C. Courts support Commissioner most of the time - There is evidence that the courts also have been increasingly more stringent in their travel and entertainment expense decisions. Instead of being taxpayer minded, the courts have supported the Commissioner of Internal Revenue most of the time. It is interesting to note, for example, that in Challenge Manufacturing Co., 37 T.C. 650, involving depreciation and expenses of a yacht, the court upheld the Commissioner's allowance of about one-half of the expenses claimed, but indicated that it thought the Commissioner had been "exceedingly generous." Elimination of the Cohan rule would have made the Commissioner's victories even more sweeping.

D. New rules operate unfairly - Admittedly, the decisions which had to be made by Congress in enacting Section 274 were difficult ones and the attempt to provide the greatest equity among taxpayers while at the same time attempting to prevent abuses made for definitional problems. Nevertheless, the new rules contain many new conceptual tests which are extremely difficult to understand and apply. The following examples indicate the manner in which these rules operate in a way which we believe to be unfair and undesirable:

1. John Jones is the head of a family manufacturing concern. The wife of his best customer enjoys classical music, so once a year John and his wife take the customer and his wife to dinner and a concert. Dinner is at a fine restaurant which provides an orchestra for dancing. This is the only time during the year that this customer is entertained, and business is discussed only in passing. The cost of the tickets to the concert clearly are not deductible under Section 274. Whether the dinner is deductible depends, in the language of the regulations, on whether the circumstances are "generally conducive to business discussion"; whether "the surroundings in which the food or beverages are furnished. . .provide an atmosphere where there are no substantial dis-

tractions to discussion"; or whether under the circumstances "there are major distractions not conducive to business discussion." An Internal Revenue agent examining Mr. Jones' return will have to measure the quantum of distraction attributable to the dance orchestra (whether or not the Jones' or their guests actually danced) in order to decide whether or not the "business meal" rule applies.

This illustration, it should be noted, relates to the whole question of goodwill entertaining which, it seems to us, is the most objectionable feature of Section 274. Scores of similar cases drawn from actual experience could be cited. Furthermore, there is an open question as to how the courts will deal with this aspect of Section 274. Why, for example, is goodwill "associated with" but not "directly related to" a business? Commentators are already raising questions as to whether the "directly related" test really is new or is merely a codification of judicial law. See "1962 Act: Is the 'Directly Related' Test for Entertainment Really New?," Journal of Taxation, December 1962, page 366.

2. Frank Smith is a wholesale grocer and sells to many small customers in his home community. The only business entertaining he does during the year is at

Christmas time when he rents a large room in a hotel and invites all of his customers and their wives to a buffet luncheon. A "walking" orchestra, which circulates around the room, is the only entertainment provided. Frank's purpose for running the party is to create or maintain the goodwill of his customers. Business, if it is discussed at all, is only incidental. Although Frank might claim that his costs were "expenditures in clear business setting," Regulations Section 1.274-2(c)(4) probably may not support this claim and he might be unable to obtain a deduction for the Christmas party.

3. As a CPA, Tom Allen may not advertise for business. His community is on a large lake, and Tom has found it very useful to entertain clients and potential clients on a boat. Tom himself does not particularly like the water and, in fact, has a tendency to seasickness which he overcomes with pills. Nevertheless, he owns a boat and uses it practically every weekend to take out his business associates. He keeps a log and can prove that his family use comprises less than 10% of the total use of the boat. On the other hand, he does not maintain that any substantial business discussions take place -- he concedes that his entertaining on the boat is of a goodwill nature, but it is of great importance

to his business. None of the maintenance expenses of the boat are deductible. The deductibility of the food and beverages consumed would depend, once again, on an Internal Revenue agent's decision as to whether the fishing activities on the boat are "substantial distractions to discussion."

4. No portion of dues paid to a country club are deductible unless the club is used more than 50% for business purposes. Many small businessmen use their club for important business activities but are not able to meet the 50% test. Suppose, for example, a businessman would not join his club but for the opportunity to use it for business purposes. Because he belongs, however, his wife and family make substantial use of the club. The businessman himself does not use the facilities nearly as often, but when he does, the use is almost always business connected. Although the standards for measuring business use have yet to be perfected, it would appear likely that no portion of the dues are deductible.

E. <u>Treasury Regulations long, complicated and vague</u> - We have indicated in the above examples a few of the problems which will be imposed on businessmen and Internal Revenue agents in applying Section 274 and the related regulations. This is not intended as a criticism of the regulations. We believe, generally speaking, that the Treasury Department attempted to interpret the statute in a reasonable way. Indeed, in some respects, the regulations, particularly in the travel expense area, are quite liberal. The problems derive from the law itself.

Nevertheless, it must be noted that the regulations are very long, complicated, and in many areas vague and difficult to understand. They cover 32 pages in one of the standard tax services. They are broken into so many subsections, paragraphs, sub-paragraphs, divisions and subdivisions that references such as Regulations Section 1.274-5(e) (2) (iii) (b) are not unusual. They are replete with passages such as: "In the light of all the facts and circumstances of the case, the principal character or aspect of the combined business and entertainment to which the expenditure related was the active conduct of the taxpayer's trade or business (or at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that the active conduct of trade or business would have been the principal character or aspect of the entertainment, although such was not the case solely for reasons beyond the taxpayer's control), etc."

We recognize that there are many complicated sections of the Internal Revenue Code and the Treasury Regulations; however, complication should only be the result of real need. What is the justification for Section 274? The purpose of Section 274 is not to eliminate deductions for legitimate travel and entertaining expenses, but merely to eliminate abuses in this area.

However, we believe our examples indicate that Section 274 actually results in the disallowance of many readily defensible entertainment expense deductions. Is it really necessary, therefore, to prevent excesses? We think it is not!

It has been suggested that Section 274 strengthens the tax structure and moral fibre of our society. Again, we disagree. In fact, resistance to overly harsh rules may have the opposite effect. There is nothing improper or immoral about legitimate entertainment and travel expenses. When based on good business judgment, they represent a reasonable attempt to increase revenue which in turn should increase taxable income.

We suggest that the continuation of Section 274 in its present form is not in the best interests of our all-important self-assessment tax system. It is needlessly complicated, disallows deductions which should be allowed, and is not necessary to curb abuses. We respectfully urge that Amendment No. 229 be enacted into law.

DEPRECIATION GUIDELINES

Amendment No. 319 to H.R. 8363, introduced by Senator Hartke for himself, and for Senators Randolph, Mc Carthy, and Javits, would establish regular use of the guideline lives prescribed in Revenue Procedure 62-21 for purposes of computing depreciation deductions. We recommend its enactment.

A. Incentive effect of guideline lives would be fully realized - The proposed amendment, would direct the Secretary of the Treasury to issue regulations that describe classes of tangible property, prescribing a useful life with respect to each class not longer than the lives specified in Revenue Procedure 62-21 and the modifications thereof announced before September 30, 1963. These lives could then be used, at the option of a taxpayer, as his basis for computing depreciation deductions without regard to the practice of the taxpayer in replacing assets being depreciated. The effect of this provision would be to allow an election to taxpayers to compute depreciation according to guideline lives, but without the limitations of the Reserve Ratio Test now contained in Revenue Procedure 62-21. The amendment also would provide that the assets be treated as fully depreciated at the end of a period equal to the life prescribed for assets of that class, thus resulting in a depreciation convention which would be simple and direct, but inflexible in its application. A similar concept of depreciation has been employed satisfactorily in Canada.

We heartily endorse the amendment as a practical and efficient way to permit taxpayers to avoid some of the intricacies of depreciation accounting for the sake of simplicity and still be in accord with

Internal Revenue Service views as to useful lives.

It has been reported by the Commerce Department that only about 55% of industry adopted the guideline procedures in 1962. Whether the failure of a larger segment of industry to adopt guideline lives was the result of an unawareness of the benefits that are available in the guideline procedures, or whether there was considerable uncertainty about the future of guideline cannot be known. Certainly, some segments of American business must have declined acceptance of the guideline procedures because they could see only a brief respite from their depreciation problems. After the initial three years of the new procedures, the Reserve Ratio Test inherent in Revenue Procedure 62-21 portended a sharp curtailment of its benefits.

B. Reserve Ratio Test a determent - We believe that Revenue Procedure 62-21, as it now stands, does not offer an adequate incentive for investment in new industrial machinery in America. The shorter useful lives of Revenue Procedure 62-21 are only a palliative not a real solution to the quest for an economic stimulant - for the incentive offered by the shorter guideline lives may be thwarted by the Reserve Ratio Test included as a part of the guidelines procedure. The effect of the Reserve Ratio Test is to permit only those useful lives that can be supported by the taxpayer's actual asset replacement experience. While it is acknowledged that Revenue Procedure 62-21 does permit a three year holiday before the Reserve Ratio Test can be brought into play, if the Reserve Ratio Test causes an adjustment in useful lives, the end result of its application will be to bring the taxpayer to the employment of useful lives which are no shorter than what is fully supportable by his own experience in replacement of assets. This is no more than taxpayers have always been entitled to under the depreciation provisions of the Internal Revenue Code. To give meaning to the guidelines procedure as an incentive to investment in industrial plant, taxpayers should be permitted a depreciation convention which embodies useful lives that are as short as the guideline lives of Revenue Procedure 62-21, but without the negative influence of the Reserve Ratio Test.

The Reserve Ratio Test is considered too complicated to be workable. Because of its complexity, the strict requirement of its use will pose a difficult problem of administration for the Internal Revenue Service. The elective treatment afforded by the proposed amendment, freeing the taxpayer from the involvements of the Reserve Ratio Test, would be of mutual benefit to the taxpayer and to the Service. The amendment would provide a simple expedient and an administratively desirable way to eliminate arguments between taxpayers and representatives of the Service.

PART III

TECHNICAL COMMENTS ON SPECIFIC PROVISIONS OF H.R. 8363

SECTION 122

CURRENT TAX PAYMENTS BY CORPORATIONS

1. PROPOSED SECTION 6655

UNDERESTIMATION PENALTIES

> The alternatives for avoiding underestimation penalties should be liberalized so that estimated tax based on the prior year's tax liability would qualify to avoid the penalty if 70% is paid instead of the present requirement of 100%.

The proposal for current tax payments by corporations increases the importance of the penalty provisions for failure to make required estimated tax payments.

Under present law, underestimation penalties are avoidable if the estimated tax payments fit any one of the following standards:

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

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

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

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

The first and fourth standards are based on 70% of the tax liability for the current year, while the second and third are based on 100% of the previous year's tax liability. It is recommended that when the prior year's liability is used as the basis for the estimated tax computation, payments of 70% should qualify to avoid penalty as in the case of estimated tax computations based on the current year's tax liability.

The provision for annualization of the current year's income, contained in the fourth standard, requires that "taxable income" be computed for each short period. This presents substantial problems of computation and may be impractical because of the difficulty of reflecting such items as possible inventory adjustments for the year, profit sharing and bonus amounts paid on an annual basis, and contributions to qualified profit sharing and pension funds normally determined toward the year end. The computation also requires an accurate determination of depreciation which otherwise might be estimated, and other adjustments, such as bad debt charge-offs, which might normally be made only once a year.

2. H.R. 8363 SECTION 122

REFUNDS OF OVERPAYMENTS

> Provision should be made for prompt refunds of overpayment of estimated tax, both as tentative refunds during the taxable year and promptly after the close of the year.

Situations will arise where profits anticipated early in a taxable year will be dissipated by an unusual event, such as a casualty, strike, etc. Under these circumstances, future payments of estimated tax may be eliminated by an amended declaration. However, there is no provision for prompt refund of amounts previously paid. Prompt refund of excess payments may be so important in individual cases that it should be directed by statute, along the following lines:

1. Statutory requirement for the prompt refund of an overpayment of estimated tax shown by the return for the year, upon application by the taxpayer.

2. Refund prior to the end of the taxable year of amounts of tentative tax paid within that year, upon application by the taxpayer.

SECTION 202

INVESTMENT CREDIT

1. PROPOSED SECTION 48(d) (2)

LESSEE-LESSOR MEMBERS OF AN AFFILIATED GROUP

This provision should be clarified to indicate that a non-member sub-lessee from a member of an affiliated group of leasing companies may use fair market value to compute its investment credit.

The amendment to existing Section 48(d) (2) should be clarified to indicate that a lessee from another member of an affiliated group will compute the investment credit based on the lessor's basis only if the lessee company itself claims the investment credit. If the lessee company in turn leases the property to an unaffiliated user and elects to pass on the investment credit, the unaffiliated user should be entitled to compute the investment credit on the fair market value of the property.

This clarification is necessary to insure that an affiliated leasing company is not placed at a competitive disadvantage to unaffiliated leasing companies where the two may be leasing the same items.

2. H.R. 8363 SECTION 202(a) (4)

EFFECTIVE DATES - REPEAL OF BASIS ADJUSTMENT

Repeal of the basis adjustment should be made effective with respect to property placed in service in years ending after enactment, and the restoration of basis to property to which the basis adjustment was previously applied should be effective as of the beginning of the first taxable year ending after enactment.

In the case of property placed in service after June 30, 1963, the repeal of the basis adjustment would apply to taxable years ending after that date; for property placed in service before July 1, 1963, the repeal would apply to taxable years beginning after June 30, 1963. Furthermore, the increase in basis provided for pre-July 1, 1963 property is to be made, pursuant to proposed Section 202(a) (2) (C), as of the first day of the first taxable year which begins after June 30, 1963.

The proposed effective dates seem to postpone unnecessarily the repeal of the basis adjustment provision. They also would result in forcing certain taxpayers to effect the basis adjustment, and compute depreciation accordingly, with respect to assets acquired prior to July 1, 1963, even though such taxpayers know at the time that the basis adjustment will be restored in the following year. In addition, the June 30, 1963 date assumes passage of the bill in sufficient time for certain fiscal-year taxpayers to apply the provisions with respect to property acquired on or after July 1, 1963.

It would appear simpler to make the provisions of proposed Section 202(a) applicable to property placed in service in taxable years ending <u>after</u> date of enactment, and to make the restoration of basis to property placed in service in prior years effective as of the <u>beginning</u> of each taxpayer's taxable year ending <u>after</u> date of enactment. The latter procedure would satisfy the intent expressed on page 37 of the House Committee Report, as follows:

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

3. H.R. 8363 SECTION 202(a) (2) (B)

RESTORATION OF BASIS ADJUSTMENT - LEASED PROPERTY

Adjustment of previously disallowed rent should be in full in the taxable year in which the basis adjustment provided in proposed Section 202(a) (2) (C) is made.

In the case of leased property with respect to which the lessee has received the credit, proposed Section 202(a) (2) (B) would provide an adjustment of previously disallowed rent "under regulations prescribed by the Secretary of the Treasury or his delegate...in a manner consistent with subparagraph (A)." The House Committee Report, at page A25, indicates that the adjustment should be "taken into account, commencing with the first taxable year beginning after June 30, 1963, over the remaining portion of the useful life used in making the decreases in rental deductions with respect to such property."

This provision appears to prolong unduly the necessity of making what in many instances may be a comparatively minor monthly adjustment. Since the adjustments required by present law to the rental deductions of lessees have only been in effect with respect to property leased after January 1, 1962, it would appear feasible to permit the full increase in rental deductions to be made in the same taxable year in which the basis adjustment provided in proposed Section 202(a) (2) (C) is made.

4. H.R. 8363 SECTION 202(c) & (d)

EFFECTIVE DATE - ELEVATORS AND ESCALATORS

> This provision should be retroactive to the effective date of the 1962 Act provision rather than July 1, 1963, since its purpose is to include a class of assets originally intended for inclusion in the 1962 Act.

The proposed effective date for qualifying elevators and escalators for the investment credit seems inequitable, particularly in view of the language in the House Committee Report indicating that elevators and escalators are closely akin to assets "accessory to the operation" of a business which are presently eligible for the investment credit. Under the proposed effective date, elevators and escalators completed or acquired before July 1, 1963 would not be eligible. It is suggested that the inclusion of elevators and escalators in the eligible asset category should be given effect <u>retroactive</u> to the enactment of the investment credit.

SECTION 203

GROUP TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES

1. PROPOSED SECTION 79(a)(1)

GROUP TERM LIFE INSURANCE UP TO TWICE AN EMPLOYEES ANNUAL COMPENSATION SHOULD NOT BE TAXED

> The arbitrary limitation of $30,000 should be amended to exempt the greater of $30,000 or twice the annual compensation of the affected employee.

A fixed ceiling on the amount of tax-free insurance coverage which may be provided employees would discriminate against employees at executive levels. Any restrictions should be on a basis that is not unreasonable and inequitable.

Many employers commonly provide employees with group term life insurance in an amount equal to twice the employer's annual compensation and some provide even greater multiples. In view of the common practice of providing employees with some multiple of compensation, we suggest that Section 203 be amended to exempt the greater of $30,000 or twice the annual compensation of an employee.

2. PROPOSED SECTIONS 79(c)

AN AVERAGE METHOD OF COMPUTING THE COST OF INSURANCE SHOULD BE PROVIDED

> The proposed method of taxation of employee's group insurance benefits should be amended to provide a third alternative method of computing premium costs, i.e. an average method similar to the one presently used in Canada.

A third alternative method of computing cost should be provided since the proposed methods would be difficult and costly for employers to apply and could result in imputing taxable income to participants in a plan paid for solely by employees without employer contributions.

It would be difficult if not impossible for employers to apply the policy cost method on a payroll period basis. In addition, payroll computations would be made more complex as a result of the proposal. They would require dealing with additional factors, such as an employee's age and insurance coverage, which are otherwise not involved in payroll computations. The additional expenses, which could be substantial, would be fully deductible and would serve to reduce the $5 million in revenues anticipated from the measure.

Adoption of the age bracket method in the provision is arbitrary in that it takes into account only one premium determining factor, albeit an important one, ignoring many others, such as the health of employees, etc.

It would seem that these difficulties could be obviated by adopting the simple method of calculating the cost of insurance in excess of $30,000 on the basis of the average premium cost to the employer per each thousand dollars of insurance coverage provided for all employees. This would enable employers to use a single rate for all employees in calculating the cost of insurance coverage instead of requiring a different rate for each age bracket. This method of calculation of cost is used in Canada and appears to be operating satisfactorily. Adoption of the average method need not change the amount of coverage exempted and would have the advantage of reducing the employer's administrative expense. Also, it would preclude imputation of income in a plan where the premiums are paid entirely by employee contributions.

SECTION 204

EXCESS MEDICAL EXPENSE RECOVERY

PROPOSED SECTION 80

INCLUDABLE EXCESS MEDICAL EXPENSE RECOVERY SHOULD BE NET OF PREMIUM COST

> Accident and health insurance premiums paid should be considered in determining the amount of the excess medical expense recovery included in gross income under this provision.

This provision would tax the "economic benefit" resulting from duplicate medical payment recoveries which escape taxation under present law. This is to be accomplished by including in income the excess of such recoveries over applicable medical expenses, as defined in Section 213(c). Health and accident insurance premiums, however, are excluded from the definition of "medical expenses" for purposes of computing the excess which is to become taxable under the proposal. (The proposal does not affect the present status of health and accident insurance premiums which would continue to qualify for deduction as medical expenses under Section 213, but which may not result in deductions because of the limitations of that section.)

It is inconsistent with the concept of income as used in our tax system to impose a tax on a gain without allowing a deduction for the cost of securing the gain. In this case the premium gives rise to the income received, and should be deductible as a cost thereof.

We recommend that taxpayers be permitted to include premium costs in the computation to determine the excess medical expense recovery which is to be taxed under this proposal. To the extent premiums are offset in this manner, they would be considered reimbursed medical expenses and therefore, not deductible as medical expenses under Section 213. This recommendation should of course be restricted to preclude the possibility of a double deduction of such premiums in case of multiple recoveries under a single policy in a given year.

It should also be noted that in view of the Ways and Means Committee's finding that proposed Section 80 would produce negligible revenues, adoption of this recommendation in the interest of fairness would not materially reduce revenues projected from this measure. Furthermore, the additional complexity occasioned by modification of the definition of medical expenses (excluding health and accident insurance premiums from the definition of medical expenses for this purpose only) is not justified by revenue considerations nor principles of equity.

SECTION 207

DENIAL OF DEDUCTIONS FOR CERTAIN STATE, LOCAL, AND FOREIGN TAXES

PROPOSED SECTION 164(b)

DEFINITIONS - DEDUCTIBLE TAXES

> The terms used to define taxes which will be deductible under the proposed provision should be defined more precisely in order to prevent serious administrative problems.

The proposal, intended to foreclose deductions for several classes of state, local and foreign taxes, is presented in terms and format which represent a major departure from present law. Present Section 164, substantially unchanged from the corresponding provision of the 1939 Code, makes all taxes deductible, with certain enumerated exceptions. Proposed Section 164(b) would enumerate four classes of deductible taxes, all others being disallowed.

It is recommended that the present structure of Section 164 be retained, with the addition of further exceptions in Section 164 (b) designed to disallow the state and local taxes which Congress intends to be nondeductible. This would avoid the confusion that may result from the present proposal.

An alternative approach would be to make the definitions in proposed Section 164(b) more precise. Some of the more obvious deficiencies in the definitions as now drafted are as follows:

Income Taxes - The phrase "Income taxes, etc." is not defined at all. It is not clear if it includes taxes on gross income, such as the Indiana gross income tax.

Personal Property Tax - As part of its personal property tax system, the State of Ohio taxes non-productive stocks and bonds, at their value. This tax would unquestionably qualify as a deductible ad valorum property tax; however, securities paying dividends or interest are taxed at the rate of 5% of their annual income yield in lieu of a tax based on their value. Although this tax is measured by income, it is a property tax. It is not clear whether this tax is deductible under proposed Section 164.

General Sales Tax - On page A42 of the House Committee Report, it is stated that rentals qualify as sales at retail for purposes of deducting taxes thereon, if so treated under applicable state sales tax law. On page A43, an example is given which indicates that the District of Columbia 4% tax on transient accommodations is not deductible, but the 3% tax on tangible personal property is deductible. This kind of fine distinction is incomprehensible to the ordinary taxpayer. The purpose of the example is to illustrate the difference in treatment of a general sales tax which would be deductible and an excise tax which would not.

It would appear that the intended purpose probably could be accomplished better by incorporating in the statute definitions of excluded excise taxes, or a list of items which are usually subject to excise taxes; e.g., tobacco, alcohol, firearms and public accommodations.

SECTION 212

MOVING EXPENSES

PROPOSED SECTION 217

PROPOSED DEDUCTION SHOULD BE BROADENED

> The proposed deduction should be expanded to encompass other expenses of relocating in addition to the basic costs of transporting the employee's household and his family.

Proposed Section 217 would allow a deduction for employees' moving expenses, but would limit the deduction to the following specific costs:

1. Moving household goods and personal effects;
2. Transportation of the employee and his family; and
3. Meals and lodging while in transit.

There are a number of other expenses usually incurred in the course of relocating, which in many cases may impose a more serious economic burden on the employee than those that would be allowed in the proposal. The additional expenses, which should be deductible along with the enumerated items include the cost of an advance trip to the new locality to search for living quarters, and living expenses incurred during a reasonable period at the new location while housing accommodations are secured. At the very least, either a deduction for a "scouting" trip, or temporary living expenses, should be allowed since the problem of finding living quarters is ever present in relocation situations.

Also, the out-of-pocket costs of acquiring and disposing of residential properties, terminating leases, etc, are normally incurred in the course of relocation, and should be deductible in accordance with the intent of the proposal.

SECTION 216

PERSONAL HOLDING COMPANIES

1. PROPOSED SECTION 542(c)(6)

   PERCENTAGE LIMITATIONS

> The percentage limitations are inconsistent and their interaction can result in inadvertent loss of exemption without violation of the purpose of this provision.

Proposed Sections 542(c)(6)(A) and (B) seem inconsistent from a practical point of view. Subparagraph (A) requires that at least 60% of ordinary gross income be from operations; Subparagraph (B) requires that other types of personal holding company income plus certain interest be not more than 20% of ordinary gross income. It would seem that for most finance companies almost all of the non-operating income would be from sources included in (B) thus, effectively, the operating income must be at least 80% of ordinary gross income for most companies rather than the 60% stated in Subparagraph (A).

There is the further requirement in Subparagraph (C) that the operating deductions must meet certain minimums. The combination of the three requirements in Subparagraphs (A), (B) and (C) will greatly increase the danger of a corporation inadvertently becoming a personal holding company through some unavoidable change in income or deductions.

2. PROPOSED SECTION 542(d)(1)(B)

   DEFINITION OF "LENDING OR FINANCIAL BUSINESS"

> The definition of finance company, which is restricted to those making loans or discounts having a remaining life of 60 months or less,

is unwarranted and will adversely affect many legitimate finance companies.

The House Committee Report (page 81) indicates that proposed Section 216 substitutes one definition of a lending or finance company for the four definitions presently in the Code, and that the proposed substitution is "in the interest of simplification." Under proposed Section 542(d)(1)(B) the term "lending or finance business," is not to include the business of "...making loans, or purchasing or discounting accounts receivable, notes, or installment obligations, if (at the time of the loan, purchase, or discount) the remaining maturity exceeds sixty months..."

No reason is given in the House Committee Report for the sixty months limitation. No such limitation appears in the present law concerning gross income derived from purchasing or discounting accounts or notes receivable or installment obligations. There is at least one industry - namely, the mobile home industry - in which present general practice is to provide seven year financing.

There seems no reason to have any limitation upon the maturity of qualifying notes or installment obligations for purposes of defining a lending or financial business.

3. PROPOSED SECTION 543(b)

TREATMENT OF RENTS AND ROYALTIES

The new 10% test (providing that a corporation with income from rents and royalties may avoid classification of such income as personal holding company income only if its total

> personal holding company income from the sources other than the one being tested does not exceed 10%) should not be imposed on top of the existing 50% test which is to be retained under the proposal.

In addition to the change to a net income concept in the application of percentage tests in the case of rents and mineral, oil and gas, and copyright royalties, a new factor is introduced into the determination of whether income from these sources will constitute personal holding company income. In general, such income is not treated as personal holding company income if it exceeds 50% of "adjusted ordinary gross income" ("ordinary gross income" in the case of copyright royalties). The new factor contained in the bill results in disregarding the 50% test if personal holding company income, including income from these sources other than income from the one being tested, constitutes more than 10% of the corporation's ordinary gross income.

This extraneous test unnecessarily complicates the personal holding company provisions and will produce such harsh results that it should be eliminated. It is obvious that the extent to which the corporation has other passive type income and income from any one of the three noted sources are entirely unrelated factors. If it is desirable to restrict more severely the extent to which income from rents and royalties may be used to shelter other types of income, it would be more appropriate to increase the required percentage of income test above 50% or to lower the overall personal holding company income percentage requirement. The different combinations of income that are possible and the different percentage relationships of the various types of income to each other defy imagination. As a result, the consequences of this provision are impossible to predict.

We urge that this type of test or condition not be expanded beyond the instances in which it is currently used in the Code.

4. PROPOSED SECTION 543(b)(2)(C)

EXCLUSION OF NON-PASSIVE INTEREST

> Interest described in the House Committee Report as "non-passive" should be considered part of "adjusted ordinary gross income" for purposes of applying the percentage test to determine if a corporation is a personal holding company.

In determining the percentage of "adjusted ordinary gross income" which consists of personal holding company income, interest on U.S. obligations of a dealer in such obligations and interest on a condemnation award, a judgment and a tax refund are excluded from both the numerator and denominator of the fraction. In effect, such interest is thus excluded from consideration in determining this critical percentage.

The House Committee Report (page 77) explains the exclusion by stating that this type of interest "in reality is not passive in nature." That being the case, we recommend that such interest in fact be treated as non-personal holding company income for this purpose. Thus, it should be excluded only from personal holding company income (the numerator of the fraction) but not from "adjusted ordinary gross income" (the denominator of the fraction) for the purpose of testing whether the corporation's passive income is sufficient in amount to make the personal holding company provisions applicable.

Ignoring such interest entirely (excluding it from both the numerator and denominator) as proposed, would normally result in a percentage somewhat lower than if such interest were considered personal holding company income (i.e. including such interest in both the numerator and the denominator.) The "non-passive interest" described in the House Committee Report should be treated in the same manner as other non-personal holding company income, that is, included only in the denominator. Such treatment would result in an even lower percentage.

5. PROPOSED SECTIONS 316(b)(2)(B) and 562 (b)(2)

INCOME IN YEAR OF LIQUIDATION

> The proposal, intended to tax individual shareholders at ordinary rates on personal holding company income not subjected to the penalty tax in the hands of the personal holding company in its year of liquidation, should be extended to include corporations.

The purpose of the proposal is, primarily, to change a situation under current tax law in which the income of a personal holding company for the year of its liquidation is not subject to the penalty tax at the corporate level, and is taxed as a capital gain upon distribution to its stockholders, both corporate and non-corporate. The means adopted in this proposal is to make sure that, with respect to non-corporate shareholders only, the personal holding company tax is avoided only if such shareholders include ordinary dividend income. Corporate shareholders, on the other hand, still would include capital gain as under existing law, and would be denied the privilege of the dividends received deduction.

The effect of the proposed partial withdrawal of capital gain treatment is to change the law in situations in which the tax is increased as a result of the change, but to retain the treatment of present law where maintaining the status quo results in greater tax. We do not believe this to be fair, and recommend that corporate shareholders of personal holding companies be granted similar dividend treatment (except in cases of the tax-free liquidation of subsidiaries). It should be noted that this suggestion may create personal holding company problems for corporate recipients which they might not otherwise have under the new law in which all capital gains are excluded from both the numerator and denominator of the personal holding company income determining fraction.

6. PROPOSED SECTION 333(g)

ONE MONTH LIQUIDATIONS

> There is no apparent purpose for denying proposed class A capital gain status to a Section 333 liquidation of a personal holding company; in fact, it is inconsistent with the intent of the proposed amendment to Section 333.

The proposed amendments grant capital-gain treatment in a Section 333 liquidation to certain earnings and profits of a corporation affected by the new personal holding company definitions instead of the dividend treatment required under present law. Regardless of the length of time the personal holding company stock has been held, such capital gain will be treated as proposed class B capital gain. Since the gain on the liquidation of a corporation under Section 331 may qualify for proposed class A treatment, although a portion (or all) of such gain is attributed to the corporation's accumulated earnings and profits, we do not see why gains attributed to earnings and profits in the situations covered by proposed Section 333(g) may not similarly qualify.

It should be noted further that the purpose of altering the usual Section 333 rules in the stated circumstances is to grant relief to corporations which will become personal holding companies because of the bill. Granting proposed class A treatment is more consistent with that purpose than is the denial of such treatment.

SECTION 219

CAPITAL GAINS AND LOSSES

PROPOSED SECTION 1212(a)

UNLIMITED CAPITAL LOSS CARRYOVER FOR CORPORATIONS

> The unlimited capital loss carryover privilege should be extended to corporations.

There appears to be no basis for confining the unlimited capital loss carryover privilege to individuals. The House Committee Report (p. 96) explains the reason for the provision as follows:

> "Similarly, the indefinite extension of the capital loss carryover is intended to increase the volume of funds available for investment in new and risky enterprises. By giving greater assurance that any capital loss incurred from a venture eventually can be offset against income otherwise taxable, the risk in such ventures is decreased, thereby making such investment relatively more attractive."

These reasons are equally valid for corporations. No reason for their exclusion is given in the House Committee Report.

SECTION 220

DISPOSITIONS OF DEPRECIABLE REAL ESTATE

1. PROPOSED SECTION 1250

ALLOCATIONS BETWEEN LAND AND IMPROVEMENTS

> Allocations of selling price between land and improvements should be afforded a statutory rebuttable presumption of correctness to limit the controversy which would result from indiscriminate reallocations by the Internal Revenue Service.

In the case of sales of improved real estate, allocations of selling price between land and improvements made in the contract of sale should be given a rebuttable presumption of correctness. This provision would tend to foreclose the endless controversy between the Commissioner and the taxpayer which might result from inherent allocation disputes.

Since the buyer and seller are adverse parties and presumably, would have opposite aims, it seems likely that the allocation between land and improvements would be determined fairly and at arms length. The Commissioner would of course be able to overcome the presumption in appropriate cases.

SECTION 221

INCOME AVERAGING

1. PROPOSED SECTIONS 1302(a) (2) and 1304(e) (1) (A)

CAPITAL GAINS

> Long-term capital gains are properly excluded from the benefits of averaging; however, taxpayers reporting capital gains are otherwise subject to discrimination under the proposed averaging provisions.

(a) The floor to which averageable income is added includes average base period capital gain net income, thus increasing the bracket at which the averageable income will be taxed. This rule applies even if the long-term gains during the base period were subject to the alternative tax. It seems unfair to use prior capital gains to increase the tax on averageable income, while at the same time excluding current capital gains (even though not subject to the alternative tax) from the averaging privilege. This inequity should be remedied by consistently including or excluding capital gains in the computations. We believe they should be completely excluded.

(b) Averageable income for the current year must be reduced by the amount by which the average base period capital gain exceeds the capital gain for the computation year. The House Committee Report (page 113) states:

> "Generally, it was thought that capital gains should be set apart and not taken into account in averaging since they, in effect, have their own specialized form of averaging. However, in those cases where the average capital gains in the base period exceed the capital gains in

the computation year, it is believed that averaging should be permitted only when total taxable income of the current year is substantially greater than the average of the base period."

Here again, it appears to be unfair and inconsistent to use long-term capital gains to reduce the benefits of averaging ordinary income. We believe, as stated in item (a) above, that long-term gains should be excluded from all of the averaging provisions. Proposed Section 1302(a) (2) should, therefore, be eliminated.

(c) In determining the tax payable in the computation year on the net long-term capital gains of a taxpayer electing to average, complicated rules apply. The primary significance of these rules appears to be in determining whether the alternative tax applies and, if so, how much the tax liability is reduced as a result thereof.

The effect of proposed Section 1304(e) (1) (A) is that the portion of the long-term capital gains of the current year which does not exceed the average base period capital gain is considered as being taxed right above the income equal to 133-1/3% of the average base period income. Only the excess of current over average long-term gains is treated as being taxed at the top bracket. This treatment is different from the usual alternative tax computation in which, in effect, includible long-term gains are all considered as being taxed at the top of all of the taxpayer's income. There appears to be no reason why these regular rules should not be equally applicable when averaging is elected, and proposed Section 1304(e) (1) (A) should be amended accordingly.

2. PROPOSED SECTION 1302(b) (2)

INCOME ATTRIBUTED TO GIFT PROPERTY

> The proposed 6% rate of income attributation is unrealistic and inconsistent with other provisions of the Code.

This provision establishes a rebuttable presumption that certain property received as a gift or bequest earns income at the rate of 6% per annum. The presumption is unrealistic and inconsistent with the actuarial tables used for gift and estate tax purposes, which use an assumed rate of income of 3-1/2%. That rate should be substituted for the 6% rate proposed.

3. PROPOSED SECTION 1302(b) (3)

WAGERING INCOME

> Wagering income is excluded from averageable income in the computation year. We question the purpose of this provision, and recommend that if it is retained, it be restricted to income from illegal gambling, and that to the extent retained, such income should also be excluded from average base period income.

We question the propriety of using the Internal Revenue Code to effect a measure of social policy by excluding gambling income from the benefits of averaging. If wagering income (which should be defined) must be singled out for less favored treatment, we believe the policy objective could be as well served if only wagering income from <u>illegal</u> gambling were excluded from the benefits of the proposal.

Furthermore, if wagering income must be deducted from averageable income in the current year, equity requires an offsetting deduction of similar wagering income included in the average base period income, at least to the extent of the amount of such income denied the benefit of averaging in the current year.

4. PROPOSED SECTION 1302(c) (2) (A)

TREATMENT OF EARNED INCOME FROM FOREIGN AND U.S. POSSESSIONS SOURCES IN COMPUTING BASE PERIOD INCOME

> Based period income is properly increased by the amount of exempt income from foreign and U.S. possessions sources to avoid a windfall in the year such exemption terminates. However, this provision penalizes unfairly a taxpayer whose exemption status does not change.

Base period income must be increased by foreign source income exempt under Section 911 and U.S. possessions source income exempt under Sections 931 and following. This is explained in the House Committee Report (page 112) as follows:

> "The inclusion of such income amounts in the base period is necessary so that the taxpayer will not become eligible for averaging merely on the grounds that during the 4-year base period, or a part of this period, he was in a foreign country and not subject to U.S. tax on his earned income. If such amounts are not included in the base period income comparable amounts earned in the United States in the computation year would be eligible for averaging."

A question arises if the taxpayer is still a foreign resident in the computation year, but receives a windfall that is subject to tax. If proposed Sections 1304(b) (3) and (4) are deleted, as we propose (see item 5 below), the effect of this provision would be to decrease the averageable windfall by the base period exempt foreign income. Even if proposed Sections 1304(b) (3) and (4) are retained, any amount by which the average base period foreign income exceeds the equivalent income in the computation year would adversely affect the windfall averaging. (It should be noted that the 133-1/3% multiplicand applied to the average base period income accentuates the problem.) Neither of these results appear to be warranted by the purpose of proposed Section 1302(c) (2) (A) as expressed in the House Committee Report. This section should, therefore, be amended to insure that it will apply only to the situation presented in the House Committee Report.

5. PROPOSED SECTIONS 1304(b) (3) and (4)

TREATMENT OF EARNED INCOME FROM FOREIGN AND U.S. POSSESSIONS SOURCES IN COMPUTATION YEAR

> The exemption of income from foreign and U.S. possessions sources must be waived by a taxpayer electing the benefits of averaging. These provisions appear unduly harsh and discriminating, and should not be enacted.

In order to qualify for averaging relief, a taxpayer must give up his tax-exemptions for earned foreign income under Section 911 and for income from sources within U. S. possessions under Section 931 and following. No other types of tax-exempt income are so treated, and we fail to see why exempt foreign and U.S. possessions income (already materially reduced by the Revenue Act of 1962) should be so discriminated against.

We recommend elimination of this requirement in conjunction with the previous recommendation for elimination of the requirement of inclusion of such income in base period income. (See item 4 above.)

SECTION 222

REPEAL OF ADDITIONAL 2-PERCENT TAX FOR CORPORATIONS FILING CONSOLIDATED RETURNS

H.R. 8363 SECTION 222

INTERCOMPANY PROFITS IN INVENTORIES

> A stated purpose of Section 222 of the bill (House Committee Report, p. 116) is to encourage the filing of consolidated returns. In accordance with this objective, and in furtherance of equitable treatment, a statutory modification of the treatment of adjustments resulting from elimination of intercompany profits and losses in inventories is recommended. Present provisions of the consolidated return regulations require the elimination of intercompany profits and losses in inventories at the beginning of the first consolidated return year following separate returns. Thus elimination of intercompany profits result in double taxation at that point which may possibly, but not necessarily, be recovered in the first separate return year following a consolidated return year. The Internal Revenue Code should be amended to provide for the elimination of intercompany profits and losses in inventories at the beginning of the first consolidated return year following separate returns of members of the same affiliated group, as the regulations presently provide, but then in that first consolidated return year, and in each of the following four years, one-fifth of the amount of such adjustment should be treated as an adjustment in determining consolidated taxable net income.

Regulations Section 1.1502-39 provides that if the members of an affiliated group file separate returns for the year immediately preceding the filing of a consolidated return, the opening inventories of that first consolidated return period must be decreased by the amounts of profits or increased in the amounts of losses reflected in such inventories which arose in transactions between members of the affiliated group and which have not been realized by the group through final transactions with persons other than members. Then, if for a later year the members of the affiliated group again file separate returns, the value of each company's opening inventory to be used in that first succeeding separate return year shall be the proper value of its closing inventory used in computing consolidated taxable income for the last consolidated return period, increased in the amount of profits or decreased in the amount of losses eliminated in the computation of such inventory as profits or losses arising in transactions between members of the affiliated group. However, the increase or decrease, as the case may be, is not to exceed (1) the similar amount reflected in the closing inventory of that first succeeding separate return year or (2) the similar amount eliminated from its opening inventory for the preceding first consolidated return period which immediately followed a preceding separate return. For example, assume that a parent corporation and its wholly owned subsidiary corporation filed separate returns for the calendar year 1963, then filed a consolidated return for 1964, and changed back to separate returns in 1965. The intercompany profit in the subsidiary company's inventory is as follows:

December 31, 1963 - $100,000
December 31, 1964 - $ 80,000
December 31, 1965 - $ 75,000

In determining consolidated taxable net income for the calendar year 1964, $100,000 of intercompany profits in inventory existing at January 1, 1964 is eliminated despite the fact that tax was paid upon it for the calendar year 1963. Then for 1965, in determining the separate return taxable income of the subsidiary, only $75,000 is added to the opening inventory. This means that over a three year span $25,000 out of the $100,000 adjustment at the beginning of 1964 has been taxed twice.

There are instances in which this opening adjustment will never be recouped even partially as in this example. If the subsidiary were liquidated into the parent during a consolidated return year, there would never be any recovery of the double taxation. Similarly again, if in a later consolidated return year the parent sells the stock in that subsidiary so that it no longer remains an affiliate, the intercompany profit in inventories at the end of the first succeeding separate return year will undoubtedly be zero so that no part of the double taxation will ever be recovered.

Equity dictates that there should never be any double taxation. It is proposed that the Internal Revenue Code be amended to provide that the adjustment to opening inventories in a first consolidated return period following a separate return year continue to be made as prescribed by the present regulations, but then that an adjustment be made in determining consolidated taxable net income of that first consolidated return year and in each of the four succeeding years for one-fifth of the amount of such intercompany profits or losses in inventories which were eliminated.

If in a succeeding year separate returns are again filed, any unamortized portion of the deferred adjustment should follow the company whose inventories were adjusted. There would then be no need for Regulations Section 1.1502-39(c) providing for a total or partial or zero restoration of the adjustment at the beginning of the first separate return year following a consolidated return year.

SECTION 223

REDUCTION OF SURTAX EXEMPTION IN CASE OF CERTAIN CONTROLLED CORPORATIONS

1. PROPOSED SECTION 1562

ANNUAL ELECTION SHOULD BE PROVIDED

> An annual election should be provided for the multiple surtax exemptions. It would be consistent with the purpose of the proposal and would eliminate many of the complexities and potential hardships.

Much of the complexity in Section 223 of the bill stems from proposed Section 1562 which provides for the multiple surtax exemption election. This election, once made (and it can be made retroactively for three years), is binding upon the members of the controlled group for all subsequent years. The election can be terminated, but it is in the termination rules that much of the complexity lies. It is here also that the Treasury is authorized to issue regulations determining "when a controlled group is terminated," and defining a "successor controlled group."

It would be much simpler to give a controlled group of corporations an <u>annual</u> election to adopt one of the three alternatives, as follows:

1. Apportion a single surtax exemption among the members of the group.
2. Elect multiple surtax exemptions and pay the additional tax imposed.
3. File a consolidated return, assuming the group is eligible.

The general reasons for Section 223 are expressed on pages 117 and 118 of the House Committee Report as follows:

1. The substantial tax reduction on the first $25,000 of income should not provide added inducement to split into multiple corporations. Therefore, the benefits of the tax reduction are limited in cases of a controlled group.

2. Groups which do not choose to file consolidated returns are to be left in approximately the same relative position as under present law.

Within these general objectives, it should be possible to give each controlled group an annual election to adopt one of the three methods prescribed. There seems no detriment to the revenue from allowing each group to elect each year.

2. PROPOSED SECTION 1562(b)(1)

ADDITIONAL TAX IMPOSED SHOULD BE LIMITED TO TAX-SAVINGS ACHIEVED THROUGH MULTIPLE SURTAX EXEMPTIONS

The additional tax imposed on any corporate member of a controlled group should be limited to the tax savings resulting from the use of surtax exemptions by the other members of the controlled group.

The additional tax is not applicable to a corporation if no other members of the controlled group have taxable income in the particular year. If, however, one other member of the group should have $100 of taxable income, then the additional tax could be $1,500 on the first corporation.

Since the purpose of the legislation is to prevent excessive savings from multiple surtax exemptions, it seems equitable to limit the additional tax to savings which are actually being realized.

3. PROPOSED SECTION 1563(e)(5)

STATUS OF COMMUNITY PROPERTY STOCK IS UNCLEAR WITH RESPECT TO "DIRECT OWNERSHIP".

The status of stock which is community property should be made clear for purposes of the direct ownership rule.

Questions will arise as to the operation of the direct ownership rule where there is stock owned as community property. For instance, a wife is not deemed to own the stock in Corporation A owned by her husband unless she also owns stock in Corporation A "directly". If the stock in Corporation A owned by her husband was acquired from community funds, does this mean that the wife has a "direct" stock ownership in Corporation A?

SECTION 302

INCOME TAX COLLECTED AT SOURCE

1. PROPOSED SECTION 3402(a)

WITHHOLDING TAX RATE SHOULD BE MODIFIED TO ALLOW FOR STANDARD DEDUCTION

> The present withholding rate is 90% of the basic tax rate, allowing for a standard deduction of 10%. The corresponding provision of H. R. 8363, which calls for a withholding rate equal to the basic tax rate in 1964, should be revised to allow for the standard deduction.

Under the present withholding provisions, the withholding rate is 18% of taxable wages as compared with the basic tax rate of 20%. The difference of 10% of the basic rate allows for the 10% standard deduction. This difference in the withholding rate has been in the law since the enactment of the Current Tax Payments Act of 1944. Under the proposal, the basic tax rate drops to 16% for 1964 and the withholding rate drops to 15%. After 1964 both the basic tax rate and the withholding rate will be 14%. No reason for ignoring the standard deduction is given in the House Committee Report.

2. PROPOSED SECTION 3402(a)

WITHHOLDING TABLE SHOULD GIVE EFFECT TO MINIMUM STANDARD DEDUCTIONS

> The withholding table does not give effect to the new minimum standard deductions, with the result that many unnecessary refund situations will be created.

On page 25 of the House Committee Report it is stated that a single individual would have no tax until his annual income exceeded $900.00; however, the withholding table provides for withholding on a monthly salary of $56.00 or an annual total of $672.00.

The House Committee Report also stated that a married couple with four exemptions would pay no tax on the first $3,000.00 of income; however, withholding is provided on monthly compensation of $224.00 which is an annual total of $2,688.00 It is assumed that the other tables would produce similar results.

It would appear that these schedules should be revised so that there would be no withholding on compensation that will yield no tax.