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RECENT DEVELOPMENTS IN THE FEDERAL INCOME TAX LAWS—A SELECTIVE SURVEY OF RECENT LEGISLATIVE AND ADMINISTRATIVE DEVELOPMENTS

J. M. WALTERS*

The purpose and intent of this article and its companion case law comment is to explore some of the recent major developments in federal tax rules and procedures. Major developments of 1962 and early 1963, apart from judicial decisions, fall primarily into three areas: (1) legislation, (2) policy proposals, and (3) administrative rules.

In exploring certain of the major developments, an attempt will be made to indicate what taxpayers may expect from these changes. Individual opinions, of course, will differ as to what is or is not a "major" development; what is "major" to one may be positively insignificant to another. The developments discussed here are those which it is hoped will be considered "major" by most taxpayers and their advisors. It is unavoidable that choices may differ and judgments of public interest are not uniform. Concerns of time and space, if nothing else, however, prohibit complete coverage. It can only be hoped that topics of major interest to many will be among those selected and noted.

I. LEGISLATION

With the foregoing introduction, we approach that area in which the developments had an overriding significance. While there were a variety of legislative enactments in 1962, most of them were of minor importance.[1] The Revenue Act of 1962,[2] is the leading legis-

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[1] *E.g.*, Pub. L. No. 87-403, 87th Cong., 2d Sess. (Feb. 2, 1962), relating to treatment of DuPont dividends received pursuant to order enforcing anti-trust laws; Pub. L. No. 87-414, 87th Cong., 2d Sess. (March 13, 1962), increasing Pub. L. No. 87-426, 87th Cong., 2d Sess. (March 31, 1962), relating to treatment of disaster losses; Pub. L. No. 87-508, 87th Cong., 2d Sess. (June 28, 1962), extending tax rates for another year; Pub. L. No. 87-858, 87th Cong., 2d Sess. (Oct. 23, 1962), relating to charitable contributions and life insurance companies; Pub. L. No. 87-863, 87th Cong., 2d Sess. (Oct. 23, 1962), doubling maximum medical expense deduction, etc.; Pub. L. No. 87-876, 87th Cong., 2d Sess. (Oct. 24, 1962), increasing maximum income eligible for retirement income credit.

[2] Pub. L. No. 87-834, 87th Cong., 2d Sess. (Oct. 16, 1962).

lative development of 1962 in the federal tax field. Second in significance was the enactment of the Self-Employed Individuals Tax Retirement Act of 1962.[3] In addition to these two major acts, the President's tax proposals as submitted to Congress in his January 13, 1963, State of the Union Address, and as developed more specifically in his Special Tax Message to Congress on January 24, 1963, rank as major developments in the tax field. While these proposals are far from being legislation, they already concern taxpayers and tax advisors and will do so in an increasing manner for several months to come. Ultimate enactments, no doubt, will affect taxpayers generally for the foreseeable future.

A. Revenue Act of 1962

As previously indicated, even in the case of major developments, no attempt will be made to explore each section of this act. Nevertheless, there are several sections of the act of considerable over all significance and an attempt will be made to explore these in some detail.

Investment Tax Credit

The administration, in its recommendations leading to the enactment of the Revenue Act of 1962, presented its proposal to Congress for the investment credit as the "central element" and a matter of "top priority in the agenda for tax reform."[4] In presenting it to Congress initially, the President included it among "additional incentives for the modernization and expansion of private plant and equipment."[5] In an appearance before the Senate Finance Committee, Secretary of the Treasury Dillon said of the investment credit:

> As chief financial officer of the Nation, I do not lightly regard tax abatements on the scale proposed here. I urge this legislation because it will make a real addition to growth consistent with the principles of a free economy . . . it will be of major assistance in strengthening our present recovery and enabling us to obtain a higher rate of growth and sustained full employment.[6]

[3] Pub. L. No. 87-790, 87th Cong., 2d Sess. (Oct. 10, 1962).

[4] Revenue Act of 1962, S. Rep. No. 1881, 87th Cong., 2d Sess. 10 (1962) [hereinafter cited as S. Rep. No. 1881].

[5] First Message on Taxation by President Kennedy, Joint Session of Congress, April 20, 1961.

[6] S. Rep. No. 1881, 10.

Section 2 of the Revenue Act of 1962 redesignates old section 38 of the Internal Revenue Code as section 39 and adds a new section 38 which allows for taxable years ending after December 31, 1961,[7] "a credit against the tax"[8] imposed by the income tax provisions[9] of the code. Also section 2 adds new sections 46, 47, 48, and 181[10] to the code.

1. Amount of Investment Credit. Section 46 provides the basic rules for determining the amount of investment credit allowable under section 38. Conceived as one means of achieving an increased rate of capital formation, the amount of the credit allowed by section 38 equals seven per cent of the "qualified investment"[11] in the taxable year, limited, however, to 25,000 dollars plus twenty-five per cent of the taxpayer's tax liability in excess of 25,000 dollars for the year. Thus, theoretically a taxpayer whose tax liability does not exceed 25,000 dollars may offset his entire liability with his investment credit. One whose tax liability exceeds 25,000 dollars may offset the first 25,000 dollars and twenty-five per cent of the balance. It should be noted, however, that there are other limitations and restrictions on the credit. The credit may be applied against income tax reduced by the foreign tax credit, the dividends received credit of individuals, the credit allowed individuals for partially tax exempt interest, and the retirement income credit. It cannot be applied against the accumulated earnings tax or the personal holding company tax.[12] Married persons filing separate returns are subject to a maximum credit of 12,500 dollars plus twenty-five per cent of the balance of tax liability. However, if one spouse has no "qualified investment" for the year and has no unused credit carryback or carryover, the 25,000 dollar maximum applies. Similarly, the maximum limitation of 25,000 dollars applies to affiliated groups, even though they do not file a consolidated return. Because of applicable limitations, the statute provides for a three year carryback and a five year carryover of unused credit.[13]

2. Qualified Investment. The term "qualified investment" means

[7] Revenue Act of 1962, § 2(h), 76 Stat. 973 (1962).
[8] INT. REV. CODE OF 1954, § 38(a) [hereinafter cited as IRC].
[9] IRC, Ch. 1, relating to normal and surtaxes.
[10] Revenue Act of 1962, §§ 2(b), 2(c), 76 Stat. 963, 966-67, 970 (1962).
[11] IRC, § 46(a)(1).
[12] IRC, § 46(a)(3).
[13] IRC, § 46(b).

the applicable percentage of "section 38 property."[14] Generally "section 38 property" includes tangible personal property and other tangible property (but not including a building or its structural components) if it is used as an integral part of manufacturing, production, extraction, or the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services, or constitutes a research or storage facility used in connection with any such activity, provided the property is subject to depreciation or amortization and has a useful life of four years or more.[15] If the useful life, determined as of the time the property is placed in service, is eight years or more, 100 per cent of the basis of the property is taken into account in determining the credit. If the useful life is six years or more but less than eight years, only 66⅔ per cent of the basis is taken into account. If the useful life is four years or more but less than six years, only 33⅓ per cent of the basis is taken into account.[16] If the useful life is less than four years, no investment credit is allowable. Furthermore, in the case of public utility property the qualified investment is limited to three-sevenths of that allowable on other "section 38 property."[17] Special rules also apply in the case of mutual savings banks, cooperative banks, domestic building and loan associations, regulated investment companies, real estate trusts, and certain cooperative organizations. If "section 38 property" is placed in service by a taxpayer to replace property destroyed by fire, storm, shipwreck, other casualty, or stolen, the basis of the "section 38 property" must be reduced by the amount of compensation or other payment received because of the casualty. In addition to these, there are a host of other rules as to what constitutes "section 38 property" and special rules[18] which require careful study before computation and utilization of the credit.

3. Recapture of Credit. Section 47 provides that where a taxpayer disposes of "section 38 property" before the end of its estimated life used in computing the investment credit, tax for the year of the disposition must be increased by recomputing the credit pre-

[14] IRC, § 46(c)(1).
[15] IRC, § 48(a).
[16] IRC, § 46(c)(2).
[17] IRC, § 46(c)(3). Generally that used predominately in the furnishing or selling of commodities or services by organizations whose rates are established or approved by a domestic governmental body or agency.
[18] IRC, § 48.

viously taken with respect of the property. This is referred to as the "recapture rule" and is to "guard against a quick turnover of assets by those seeking multiple credit."[19] In general, "section 38 property" is disposed of when it is sold, exchanged, transferred, distributed, involuntarily converted, or given away. Thus, adjustments to tax otherwise payable for the year may have to be made when (1) property is contributed to a partnership or a corporation, (2) property is converted to personal use (and depreciation thereby is no longer allowable), or (3) property is used predominately outside the United States, by a governmental unit. These are examples cited by the committee report,[20] but they are enough to constitute fair warning that the taxpayer must be extremely careful in transferring or acquiring "section 38 property." Taxpayers now find themselves back where they were a few years ago when one selling a corporation wanted to sell stock and the purchaser wanted to buy assets instead of stock[21] despite the fact that an earlier Congress changed the law to permit the parties to work the situation out satisfactorily for both the purchaser and the seller.[22]

4. *State Laws and Rulings.* From the foregoing it is apparent that this new credit provision, enacted as an "investment stimulation," is extremely technical and complex. Further complexity is injected by the various state laws and rulings. Some states are allowing the credit against state tax liability; others are disallowing it entirely; and still others are allowing it in one form or another, but not as a credit, *e.g.,* North Carolina and South Carolina.

In North Carolina the Commissioner of Revenue initially ruled that North Carolina would not allow taxpayers (1) to claim the investment tax credit against their North Carolina income tax liability or (2) to take additional depreciation in the year of acquisition of the "section 38 property."[23] Later the Commissioner changed the ruling to provide that:

> Effective for income years ending after December 31, 1961, for North Carolina income taxpayers the original basis of property which qualifies for investment credit under Section 38 of the Internal Revenue Code of 1954 *must* be reduced

[19] S. Rep. No. 1881, 18.
[20] S. Rep. No. 1881, 149.
[21] Tax Ideas, Report Bull. No. 2, Jan. 22, 1963, at 7.
[22] IRC, § 337; S. Rep. No. 1622, IRC, at 254.
[23] 2 CCH State Tax Cas. Rep. *N.C.* ¶ 200-940.

by an amount equal to the reduction in basis required for Federal purposes. This adjustment of the basis:

(a) *must* be made before the depreciation deduction otherwise allowable is determined;

(b) the taxpayer *must* claim as an additional depreciation deduction an amount equal to the amount of the reduction in basis allowable by reason of the federal tax credit provisions; and

(c) this additional depreciation deduction *must* be claimed during the income year in which the Section 38 adjustment is allowed or required for federal purposes.[24]

South Carolina has ruled that it will not allow the credit as such, but will *permit* the taxpayer to adjust the original basis of the "section 38 property" by claiming an additional depreciation deduction equal to the amount of the basis adjustment in the year in which the property is placed in service.[25] According to the regulation, this is permitted so the taxpayer may use the same depreciation schedule for federal and South Carolina purposes. Under an alternative the South Carolina taxpayer may elect (irrevocably) to adjust the basis and recover it at the end of the life of the asset by increasing depreciation or by recovery of basis on disposition. Both North Carolina and South Carolina require adjustments in the basis of property in the event that the taxpayer is required to make adjustments for federal tax purposes.

Despite all the complexity the taxpayer has no choice but to claim the investment tax credit. Under the Interal Revenue Code the basis of any "section 38 property" must be reduced for purposes of determining depreciation, gain or loss on sale or exchange, etc., by an amount equivalent to seven per cent of the "qualified investment."[26] Faced with this the taxpayer or his advisor must struggle through the complexities of the investment credit provisions. Even though it is questionable whether these new provisions will "get the country moving again" as to capital investments, they assuredly should be a real boon to the manufacturers of aspirin!

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[24] 2 CCH STATE TAX CAS. REP. *N.C.* ¶ 200-941. (Emphasis added.)

[25] 1 CCH STATE TAX CAS. REP. *S.C.* ¶ 200-179; 1 CCH STATE TAX CAS. REP. *S.C.* ¶ 10-607d.

[26] IRC, § 48(g); S. REP. No. 1881, 164.

Lobbying Expenses

Section 3 of the Revenue Act of 1962, like section 2, gives us a "new direction" in the tax field. Fortunately section 3 is shorter and probably more understandable than the investment credit provisions. In brief, section 3 amends section 162 of the code, which relates to ordinary and necessary business expense deductions, so as to allow the ordinary and necessary expenses of a trade or business to be deducted when paid or incurred in the taxable year (1) in direct connection with appearances before, submission of statements to, or sending communications to the committees, or individual members, of federal, state, or local legislative bodies with respect to legislation or proposed legislation of direct interest to the taxpayer; (2) in direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization; (3) as dues to any organization attributable to activities described, and in direct connection with communication of information between the taxpayer and employees or shareholders with respect to any such legislation.[27] In short, certain lobbying expenses are deductible for taxable years beginning after December 31, 1962. Lobbying expenses prior to that date were not deductible. The regulation[28] was of long-standing duration and had been declared valid by the Supreme Court even though there was no statute to support the regulation.[29] While this change at first glance may not appear to be a major development, or may even cause one to wonder if it really changes anything in practice, it must be recognized as a significant development when one considers how long and how hard proponents of the measure worked to obtain its enactment, and the nature of the subject involved.

Section 162(e) of the code specifically prohibits deduction of amounts paid or incurred in campaigns of political candidates, and in influencing the public on legislative matters, elections, or referendums. Now that the dike is punctured with respect to lobbying expenses, one might speculate as to how and when the above provision will be amended to grant further relief in the lobbying area. Doubtless some lobbying expenses should be allowable deductions; however, just

[27] IRC, § 162(e).

[28] Treas. Reg. 118, §§ 39.23(a)-1(f), 39.23(q)-1(a) (1953).

[29] Cammarano v. United States, 358 U.S. 498 (1959).

which should be allowed and which disallowed is a most difficult question. Further no one can deny the danger in going too far in allowing lobbying expenses. The new provision may be just "a foot-in-the-door." In any event this feature is one to be watched carefully. It is doubtful whether the enactment of the Revenue Act of 1962 has settled this issue for long.

Travel and Entertainment Expenses

Section 4 of the Revenue Act of 1962 adds new section 274 to the Internal Revenue Code. Under this new section, certain expenses previously deductible in full will be partially or completely disallowed after December 31, 1962. The section deals exclusively with disallowance and does not provide for deduction of any expenses. To be deductible expenses still must meet the tests of other provisions dealing with deductions (*e.g.*, sections 162, 165, 167, and 212).

In his first message on taxation,[30] President Kennedy "stated his conviction that entertainment and related expenses, even though having a connection with the needs of business, confer substantial tax-free personal benefits on the recipients, and that in many instances deductions are obtained by disguising personal expenses as business expenses. He recommended that the cost of such business entertainment and maintenance of entertainment facilities be disallowed in full as a tax deduction and that restrictions be imposed on the deductibility of business gifts and travel expenses."[31] The Senate Finance Committee observed in its report[32] that much of the abuse prompting the recommendation could be traced to the "broad judicial and administrative interpretation given to the term 'ordinary and necessary' " since under prior law all the taxpayer needed to do to support his deduction was to show a business purpose, even though slight, and his entertainment expenses were allowable. Further, under the *Cohan* rule, the taxpayer did not even have to prove the amount of his expenditures. If he established that he had paid or incurred some entertainment expenses and that they were "ordinary and necessary," he generally would be allowed to deduct an estimated amount. The application of this rule stemmed from the decision in

[30] First Message on Taxation by President Kennedy, Joint Session of Congress, April 20, 1961.
[31] S. Rep. No. 1881, 24.
[32] S. Rep. No. 1881, 25.

Cohan v. Commissioner.[33] There it was held that when the evidence indicated that the taxpayer had incurred deductible expenses but the precise amount could not be determined, the court must make "as close an approximation as it can" rather than disallow the entire deduction claimed.

It is the avowed purpose of the new section 274 to restrict deductions for entertainment and travel expenses and business gifts to prevent abuses,[34] and certainty it is safe to predict that the provision will reduce materially the aggregate amounts of such deductions allowed. In the first place, some taxpayers who legitimately might deduct some entertainment and other business expenses will forfeit that right rather than comply with the detailed record keeping requirements. Secondly the cheaters will find it substantially more difficult hereafter to establish their deductions and therefore will make them more realistic. If the cheaters try to continue their previous ways and support their claims by fabrication of records, they will invite prosecution for fraud. This to many may sound severe, but it is entirely realistic and justifiable under the laws enacted by Congress.

When the Internal Revenue Service issued proposed regulations, the protestants were many, and *loud.* The cry always is loud when people are hurt in their pocketbooks! The proposed regulations did not appear to be extreme in view of section 274. In general they reflected the provisions of the new section and the congressional committee reports.[35] This, however, did not save the Commissioner of Internal Revenue from the verbal brick-bats. Following the public hearings on the proposed regulations the Service issued final regulations reflecting some recognitions of the protests and a relaxation of its more extreme positions.[36] With section 274 "on the books" the Service cannot be criticized for these regulations or its announced policy to police deduction of entertainment and travel expenses. The Service would be derelict in the performance of its duties if it were to do less; nevertheless, the protests are continuing with increasing fervor. The protests are so loud that the Commissioner has been invited to a closed session of the Senate Finance Committee to dis-

[33] 39 F.2d 540 (2d Cir. 1930).
[34] S. Rep. No. 1881, 25.
[35] S. Rep. No. 1881, 24-38, 169-78; H.R. Rep. No. 1447, 87th Cong., 2d Sess., 19-26, A-28 to A-37 [hereinafter cited as H.R. Rep. No. 1447].
[36] Treas. Reg. § 1.274-5 (1962); T.D. 6630, Dec. 27, 1962.

cuss the "expense account curbs" and signs indicate some members of Congress may want to enact legislation to ease the provisions of section 274.

Just what does section 274 do? In general it "tightens" the rule applicable in the expense account area. Under the new and stricter rules—which apply to taxable years ending after 1962, but only to expenditures made after December 31, 1962—many taxpayers will have to change their expense account practices or lose their deduction for entertainment, travel, and similar expenditures. In any case of a fiscal year straddling January 1, 1963, both sets of rules apply for the appropriate periods, *i.e.*, for such a year, the old rules apply through December 31, 1962, and the new rules thereafter.

1. Entertainment Expenses. Under the new rules, to be deductible, entertainment expenses not only must be ordinary and necessary, they must also (1) be *directly related* to the active conduct of the taxpayer's trade or business, or (2) be *associated with* the active conduct of the taxpayer's trade or business if they are incurred directly preceding or following a substantial, *bona fide* business discussion.

While the Revenue Act of 1962 does not define the term "directly related to," taxpayers can anticipate a strict interpretation in the regulations. In this respect the congressional committee reports are of some help. The Report of the Committee on Ways and Means indicates that the following are ordinarily *not* "directly related to" a taxpayer's trade or business.[37] *(1) Goodwill type expenditures.* The hope or expectation of deriving some business from the person entertained, at some indefinite future date, is not enough; there must be an expectation to derive income immediately, even though that does not in fact happen. *(2) Absentee type expenditure.* If the taxpayer or his representative is not present, the entertainment ordinarily is not directly related to business. Thus, costs of theater tickets, World Series tickets, etc., would not be deductible if the taxpayer merely gives them to customers. *(3) Expenditures where conditions are not conducive to conducting business.* If the expenditures are in connection with an event or entertainment where there is little or no possibility of conducting business affairs or discussions (prizefights, theaters, race tracks, night clubs etc.) a deduction is not allowable. There must be *opportunity* for the conduct of business

[37] H.R. REP. No. 1447, A-28 to A-30.

affairs or discussion, even if it does not in fact occur. If the group entertained is large, or the distractions substantial, the taxpayer must prove a direct relationship to the active conduct of his trade or business in order to deduct the costs.

The Senate Finance Committee Report sets out the following additional examples of entertainment expenses ordinarily *not* deductible.[38] *(1) Expenses of cutomer's family and others.* The costs of tickets for a buyer's wife and family where the taxpayer takes the buyer and his family to the theater. *(2) Expenses violating public conscience.* The following are illustrative: (a) the cost of liquor if the serving of it violates the public morals of the community as expressed by local law; and (b) the cost of "call girls" to entertain clients. The Senate report says that these expenses are in "no legitimate sense" directly related to the taxpayer's trade or business.[39]

Where the taxpayer incurs entertainment expenses directly preceding or following a *substantial, bona fide* business discussion (such as business meetings at a convention), he does not have to prove they are "directly related to" provided he can show that they are "associated with" the active conduct of his trade or business. This rule apparently would allow deduction for entertaining primarily to encourage goodwill where the evidence of business connection is clear. Until the Treasury Department issues regulations, one cannot be sure just how to distinguish between expenses "associated with" and "directly related to" the active conduct of a trade or business. Review of the Congressional Committee Reports, however, indicates the following would be deductible:[40] (1) Expenses for entertaining business associates and their wives in the evening following substantial and bona fide business negotiations, or in the evening preceding the negotiations if the business associates come from out of town; (2) Expenses for entertaining business associates or prospective customers between meetings, or in evenings after the meetings, at a business convention; (3) Expenses for entertaining which is a part of substantial and bona fide business discussion where the conduct of business is the principal activity during the combined entertainment and business time; and (4) Costs of banquets, luncheons, etc., at meetings of professional and business associations. In

[38] S. Rep. No. 1881, 28.
[39] S. Rep. No. 1881, 29.
[40] H.R. Rep. No. 1447, A-33; S. Rep. No. 1881, 174.

such cases if the expense is "associated with" the active conduct of a trade or business, it is not necessary for the taxpayer to attend the performance or to be present. For example, a law book publisher would be allowed to deduct the cost of a table at a bar association banquet for lawyers who are actual or prospective customers for its law books even though no representative of the publisher is present.

Section 274(e) excepts certain business expenses, if ordinary and necessary, from the restrictive rules of section 274(a). Thus expenditures for the following will be deductible without being subjected to the "directly related to" or "associated with" tests: (1) business meals (lunches or dinners for customers or prospective customers under conditions conducive to conduct of business affairs or discussion); (2) employees and executive meals furnished on the business premises; (3) compensation to employees on which income taxes have been withheld (*e.g.*, a vacation trip for a man and wife); (4) reimbursed expenses in connection with performance of services for another person (*e.g.*, entertainment by lawyer, accountant, or agent in behalf of a client); (5) recreational and social activities primarily for employees (*e.g.*, swimming pool, club, baseball diamond, etc., for use primarily by employees); (6) business meetings of employees, stockholders, agents, directors etc.; (7) business meetings and conventions of a tax-exempt business leagues, chambers of commerce, etc.; (8) goods, services, facilities, or entertainment furnished to or for the general public; and (9) entertainment sold to customers.

Under the new rules entertainment expenses must be set out as such on tax returns. They no longer will be "buried" under accounts such as advertising or public relations. Furthermore, the taxpayer must keep adequate records on expense account items, which records should be kept contemporaneously. As indicated earlier, under the old rules if the taxpayer could not prove exactly how much he spent for entertainment, he was allowed under the *Cohan* rule a deduction based on estimates. Hereafter, however, to deduct entertainment, amusement or recreational expenses, or expenses with respect to facilities used for such activities, the taxpayer must have adequate records or sufficient evidence to prove: (1) amount of the expenses; (2) time and place of the entertainment, use of the facility, etc.; (3) business purpose of the expense or item; and (4) business rela-

tionship to persons entertained or using the facility. Section 274(d) specifically and categorically overrules the decision in *Cohan v. Commissioner*.[41]

Hereafter, to deduct expenses with respect to an entertainment, amusement, or recreational facility, the taxpayer must show that he used it *primarily* (more than fifty per cent) for business purposes. Even so, he can deduct only that portion of the total expenses "directly related to" the active conduct of his trade or business. Thus it will be imperative, beginning January 1, 1963, to keep a complete and detailed log book or diary recording the use of and the persons using an entertainment facility. What constitutes such a facility? Some examples are a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, hotel suite, house in vacation resort, or an airplane. Dues paid to a social, athletic or sporting club will also be treated as expenses of a facility. Thus, unless the facility is used *primarily* for business purposes, none of the dues are deductible. If it is used primarily for business purposes, that portion of dues attributable to business is deductible.[42]

As indicated more proof will be required under the new rules than heretofore required. The congressional committee reports make this clear. The Finance Committee Report states that the new rules "contemplate more detailed record keeping than is common today in business expense diaries,"[43] and the regulations issued to date substantiate this interpretation.[44] A business diary may be adequate to satisfy the new rules, but only if it shows dates, amounts, nature and business purposes, and business relationship. Furthermore, the taxpayer's record must relate to separate expenses or items; it will not be sufficient to record and explain only aggregate amounts.

In addition to keeping adequate records, the taxpayer should retain receipts, cancelled checks, bills, stubs, or other such evidence to support his records. The taxpayer under these regulations should with few exceptions, obtain and keep itemized receipts for any expenditure of twenty-five dollars or more. For incidental expenses, such as cab fares, tips, business lunches, not exceeding twenty-five dollars, the business diary or other record will be sufficient; it will

[41] S. Rep. No. 1881, 173.
[42] IRC, § 274(a); S. Rep. No. 1881, 169.
[43] S. Rep. No. 1881, 35.
[44] Treas. Reg. § 1.274-5 (1962); T.D. 6630, Dec. 26, 1962.

not be necessary to obtain and keep receipts for such expenses. Also in certain other cases, it will not be necessary to keep receipts, *e.g.*, expenses of travel on a per diem not exceeding twenty-five dollars; however, even in this case the Service has warned that the best evidence to substantiate the travel may be the hotel receipt for lodging.

One assuredly must anticipate a resounding change from earlier treatment of entertainment, travel, and related expenses. No doubt "the way of life" of many individuals will be changed drastically in the next year or two because of these new provisions. Some protestants are crying that many businesses (bars, cafes, night clubs) will fold,[45] and they may. If one considers the over-all fibre of our federal tax structure, however, and the necessity for and the merits of our voluntary self-assessment system, he cannot avoid recognizing some merit in requiring *all taxpayers* to prove absolutely their deductions in the "expense account" area. One cannot sympathize too much for those that crieth loudest, even though he knows a few honest taxpayers will be hurt in the process.

2. *Travel Expenses.* Prior to the 1962 Revenue Act, if the primary purpose of travel was for business, the entire amount of the travel expenses was deductible. On the other hand if the travel was primarily personal in nature, no part of the traveling expenses was deductible even though the taxpayer conducted business during the travel. No doubt some enterprising taxpayers have found business reasons to make trips to resorts or vacation spots or other places with some personal attraction. The advantage of writing off the cost of traveling to and from these places, as well as expenses at the destination properly attributable to the trade or business, enhanced the incentive to travel to such places. Section 274(c) of the new act denies deduction for travel expenses after December 31, 1962, to the extent they are not allocable to the taxpayer's trade or business. The traveler now must meet two tests with respect to travel expenses; (1) the expense must be deductible under section 162 (ordinary and necessary to trade or business) or section 212 (incurred to produce or preserve income) *and* (2) the expense must meet the allocation rule of section 274(c). Thus, if the tests of sections 162 or 212 are not met, none of the expense is deductible; if those tests are met, then only that portion allocable to business is deductible.

The allocation rule was enacted to prohibit deduction of travel

[45] US News & World Report, March 11, 1963, p. 39.

expenses for trips to vacation resorts on the pretense of engaging in business activity. Recognizing the need or desirability of some mitigation of the rule "in cases where the possibilities of abuse are relatively small,"[46] Congress wrote into the law a prohibition against application of the allocation rule to the expenses of any travel away from home which does not exceed one week or where the portion of the time away from home which is not attributable to the pursuit of the taxpayer's trade or business, or an activity described in section 212, is less than twenty-five per cent of the total time away from home on such travel.[47] The new rule coupled with the required substantiation of travel expenses attributable to business and the danger in trying to support a deduction by fabrication of records will probably reduce materially deduction of travel expenses in questionable cases.

3. Business Gifts. Before leaving section 274 some comment should be made on the new rule limiting deductions for business gifts.[48] In general any expenditure for a gift or gifts to an individual aggregating more than twenty-five dollars in the year is not deductible. According to the Senate Finance Committee Report,[49] an item excludable from the recipient's gross income other than under section 102 is not a "gift" for these purposes. That committee report illustrates this by saying that an employer's payment to a deceased employee's widow, excludable from her income under section 102, is not deductible by the employer in excess of twenty-five dollars, because such an item, excludable under section 102, is a "gift"; whereas, the employer's deduction would not be limited if the payment is treated as a death benefit excludable from her income under section 101(b).[50]

The statute specifies three exceptions to the term "gift." It does not include an item costing the taxpayer no more than four dollars, if the taxpayer's name is clearly and permanently imprinted on it and it is one of a number of identical items distributed generally by the taxpayer. This takes care of the case where a merchant hands out inexpensive pens or pencils to customers and prospective customers. The second exception removes from the gift category any sign, dis-

[46] S. Rep. No. 1881, 172.
[47] IRC, § 274(c).
[48] IRC, § 274(b).
[49] S. Rep. No. 1881, 170.
[50] *Ibid.*

play rack, or other promotional material to be used on the business premises of the recipient. The third exception removes an item of tangible personal property costing the taxpayer not more than 100 dollars which is awarded to an employee because of his length of service or for his safety record.

Other Provisions of the 1962 Act

1. *Distributions in Kind from Foreign Corporations.* Section 5 of the Revenue Act of 1962 adds a new provision to section 301(b)(1) of the code which provides that, generally, where a foreign corporation makes a distribution in kind to a domestic corporation, the amount of the distribution for dividend purposes shall be the fair market value of the property distributed. Heretofore the distributee was required to include in its income as a dividend only the lesser of the fair market value or the adjusted basis in the hands of the distributor. There is an exception to the general rule where a dividend received deduction is allowable under section 245 in respect of the distribution. Where the amount of a distribution is determined pursuant to the new provisions, the basis of the property distributed in the hands of the distributee shall be the amount of the distribution.[51]

2. *Mutual Savings Banks.* Section 6 of the new act amends section 593 of the code to provide a new method for determining the deduction for additions to bad debt reserves allowable to mutual savings banks, domestic building and loan associations, and cooperative banks. When Congress subjected these institutions to the regular corporate income tax for the first time in 1952, it also provided for them special deductions for additions to bad debt reserves. Under those provisions their deductions "proved to be so large that they have remained virtually tax exempt. . . ."[52] In addition, under the new provision the definition of a "domestic building and loan association" was changed from an association substantially all of whose business is confined to making loans to its members to one which is an insured institution under the National Housing Act or which is subject by law to supervision and examination by state or federal authority having supervision over such associations, but only if substantially all of its business consists of accepting savings

[51] IRC, §§ 301(b)(1)(C), 301(d)(1)(3).
[52] S. REP. No. 1881, 40.

and investing in loans secured by or for the improvement of certain specified types of real property. The new rules also require that at least ninety per cent of the assets of an association be invested in cash; United States, state, or local government, or governmental instrumentality obligations; loans secured by an interest in real property; loans secured by a member's deposit; or property acquired through default of real property loans. In general the new provisions alter substantially the tax status of these associations, and the net effect is to increase materially the taxes they will pay for taxable years ending after December 31, 1962.

3. Foreign Trusts. Prior to enactment of the 1962 act, United States citizens could, with relative ease, establish foreign trusts so that very little or no U.S. tax would be due on the trust income currently or upon termination of the trusts. In addition, these trusts ordinarily would be created in foreign countries imposing little or no tax on the income. Thus it was possible for trust income to be realized, accumulated, and distributed with no income tax being paid on it. Section 7 of the 1962 act amends several sections of the Internal Revenue Code to tax United States beneficiaries of foreign trusts created by U.S. grantors, settlors and transferors in substantially the same manner as if the income had been distributed when earned, on a basis comparable to the taxing of beneficiaries of domestic trusts. Thus another possible way to reduce income tax was curtailed; however, only distributions accumulated after the enactment of the 1962 Revenue Act are subject to the new rules. According to the Senate Finance Committee, this was "not viewed . . . as imposing a penalty but rather as a method for placing U. S. beneficiaries of foreign accumulation trusts created, or added to, by Americans in substantially the same way as the beneficiaries of domestic trusts distributing their income currently."[53]

4. Mutual Fire and Casualty Insurance Companies. Section 8 of the Revenue Act of 1962 changes substantially the taxation of mutual fire and casualty insurance companies. Since 1941 these companies have been taxed pursuant to special formulas which did not take into account their underwriting income or losses, and those companies having receipts not in excess of 75,000 dollars have been tax exempt. Based on a Presidential recommendation,[54] the

[53] S. Rep. No. 1881, 51.
[54] S. Rep. No. 1881, 54.

amendments would tax these companies at the ordinary corporate rates on their total income (*i.e.*, investment and underwriting) reduced temporarily by certain amounts set aside as protection against loss. Under the amendments these companies eventually will be required to pay tax on their total income. Thus, while not a development involving a great number of taxpayers, this is a significant development to the particular industry and indirectly to all taxpayers.

5. Domestic Corporations Receiving Dividends from Foreign Corporations. Another change not affecting individual taxpayers directly but which is of significance is reflected in Section 9 of the Revenue Act of 1962, which amended section 902 of the Internal Revenue Code (relating to credit for corporate stockholders in foreign corporation) and added new section 78 (relating to dividends received from certain foreign corporations). Under the code before enactment of the 1962 act, and even now to a limited extent since the new rules do not apply to all foreign dividends received until after December 31, 1963, a domestic corporation, owning at least ten per cent of the stock of a foreign corporation at the time it receives dividends from the foreign corporation, obtains a credit for foreign taxes paid by the foreign corporation. Since the domestic corporation includes in its gross income only the dividends actually received, allowance of the foreign tax credit has been considered an "over-allowance" or a "double allowance." Where a foreign government taxed 1,000 dollars of income of the foreign corporation at thirty per cent, only 700 dollars could be paid to the domestic stockholder. If the U.S. tax on the 700 dollars is 364 dollars (fifty-two per cent), and the allowable credit after applying limitations is 210 dollars, the U.S. tax on the dividend is only 154 dollars ($364 — $210). Thus the total U.S. and foreign taxes in such a case is 454 dollars ($154 + $300). But if the 1,000 dollars were earned by a branch of the domestic corporation, the total tax would be 520 dollars. Because of the sixty-six dollar reduction in over-all taxes, the President in his 1961 tax message to Congress recommended legislation to correct the "double allowance."[55]

Under amended section 902 of the code, if the domestic corporation elects to take a foreign tax credit instead of deducting foreign taxes it is required to "gross-up" its foreign dividend income by adding to the amount actually received the foreign taxes deemed paid

[55] H.R. REP. No. 1447, 50.

with respect to the dividend received. Thus in the above example the domestic corporation would report 1,000 dollars instead of 700 dollars and the full 300 dollars of foreign taxes would be allowed as a credit. The "gross-up" rule does not apply in the case of "less developed country corporations."

Even though Congress agreed with the President "that in the interest of uniform tax treatment this double allowance in the case of dividends from foreign corporations should be removed,"[56] and enacted provisions to accomplish that aim, it is doubtful whether the full aim has been accomplished. Domestic corporations operating abroad will seek ways to qualify their foreign corporations as "less developed country corporations." Because of the cost of these new provisions and the possibilities for avoiding or reducing that cost, domestic corporations will make this an active area taxwise in the foreseeable future.

6. Income Earned Abroad. Section 11 of the Revenue Act of 1962 makes significant changes in the rules governing the exclusion of income earned abroad by individuals. Section 911 of the Internal Revenue Code (relating to earned income from sources without the United States), as amended by section 11 of the 1962 act, limits the exclusion with respect to earned income from foreign sources. Previously an individual United States citizen who was a bona fide resident of a foreign country could exclude from his gross income his entire earned income from sources without the United States. Also, the individual who did not establish a foreign residence could exclude up to 20,000 dollars annually if he was abroad for a period of seventeen out of eighteen consecutive months. While the President recommended that there be no exclusion for income earned abroad in developed countries, and that the exclusion of up to 20,000 dollars a year be allowed only where the individual is a bona fide resident of or remains abroad seventeen out of eighteen months in a less developed country,[57] Congress wrote provisions limiting the exclusion for income earned while a bona fide resident of a foreign country to 20,000 dollars per year for the first three years and thereafter to 35,000 dollars. The primary provisions allowing the exclusion where the individual remains abroad for seventeen out of

[56] H.R. Rep. No. 1447, 52.
[57] H.R. Rep. No. 1447, 54.

eighteen months were retained.[58] In the past some individuals avoided U.S. income taxes as bona fide residents of foreign countries and at the same time by one means or another were held not subject to tax as a resident of the foreign country, thereby achieving the ideal—having income not subject to taxes! To end this practice Congress wrote into section 911 the rule that an individual is not to be treated as a bona fide resident of a foreign country if he has earned income in the foreign country, has made a statement to the authorities of that country that he is not a resident of it, and has been held not subject as a resident to that country's income taxes.[59]

A further change affects the taxation of the pensions of U.S. citizens attributable to periods of foreign service. Employer contributions toward the pension of an employee attributable to service when he was a bona fide resident of a foreign country, or was in a foreign country for seventeen out of eighteen months or more, formerly were treated in the same manner as the employee's own contributions, and therefore were not taxable to him. This rule applied even though he was living in the United States at the time of drawing his pension. Under the amendments of the Revenue Act of 1962, employee contributions made after December 31, 1962, will be fully taxable to the employee when he receives his pension. A further change provides that deferred compensation received after the end of the taxable year following the year in which services are preferred is not to be eligible for the exclusion of income earned abroad. Formerly such compensation was excluded from gross income so long as it was "attributable" to a period when the employee was a bona fide resident of a foreign country. These changes no doubt will make foreign service somewhat less attractive to U.S. citizens.

7. *Controlled Foreign Corporations.* Section 12 of the 1962 act amended the Internal Revenue Code by adding to part III of subchapter N of chapter 1 (which relates to income from sources without the United States) an entire new subpart F, relating to controlled foreign corporations. Under the law prior to the Revenue Act of 1962, foreign corporations, even though American controlled, were not subject to United States income taxes on their foreign source income until the foreign corporation paid dividends to the

[58] IRC, § 911(a).
[59] IRC, § 911(c)(6).

American stockholders. This quite naturally afforded opportunities for effective tax management, and critics of this "tax deferral" were aroused. In his 1961 tax message to Congress President Kennedy questioned the desirability of this tax deferral in the case of U.S.-controlled foreign corporations. He stated:

> The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprizes organized abroad by American firms have arranged their corporate structures—aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven—so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.

The President recommended:

> [E]limination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation. There is no valid reason to permit their remaining untaxed regardless of the country in which they are located.[60]

While Congress did not enact the President's recommendations in full, they were nevertheless impressed with the President's recommendations and were convinced that many American firms were taking advantage of the multiplicity of tax systems to avoid paying what ordinarily could be expected of them in the United States.[61] As a result Congress ultimately enacted provisions under which certain types of income of controlled foreign corporations, even though undistributed, will be taxed to U.S. stockholders currently—in the year

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[60] H.R. REP. No. 1447, 57.
[61] H.R. REP. No. 1447, 58.

earned by the foreign corporation—except where operations are in "less developed countries."[62]

As can be imagined, these new provisions are extensive and complex. In general a "controlled foreign corporation" is one more than fifty per cent of whose combined voting power of all classes of stock entitled to vote is owned directly or constructively by U.S. stockholders on any day during the taxable year of the foreign corporation.[63] Generally two types of undistributed income are currently taxable to U.S. stockholders: (1) income derived from insurance or reinsurance of U.S. risks and (2) "foreign base company income." The latter type includes foreign personal holding company income, foreign base company sales income, and foreign base company services income. With certain exceptions personal holding company income is of a "passive character," *e.g.,* dividends, interest, annuities, royalties, etc.[64] Foreign base company sales income is that derived from the purchase and sale of personal property either purchased from or sold to a related person, but only if the property is manufactured, produced, grown, or extracted outside of the country where the controlled foreign corporation is organized and the sale is for use outside that country. Furthermore, if any significant amount of manufacturing, assemblying, or construction is performed by the selling corporation (the "base company"), the income therefrom is not "foreign base company sales income."[65] Likewise, "foreign base company services income" is income derived from the performance of technical, managerial, scientific, or similar services for a related person outside of the country in which the controlled foreign corporation is recognized.[66] The intent as to foreign base company sales and services income is to deny tax deferral where a subsidiary "is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax" for the sales or services income.[67]

What constitutes a "less developed country corporation"? What constitutes a "less developed country"? Congress answered the latter question by saying it means "any foreign country (other than an

[62] IRC, § 951-64.
[63] IRC, § 957.
[64] S. Rep. No. 1881, 82.
[65] S. Rep. No. 1881, 84.
[66] *Ibid.*
[67] *Ibid.*

area within the Sino-Soviet bloc) or any possession of the United States with respect to which, on the first day of the taxable year, there is in effect an Executive order by the President of the United States designating such country or possession as an economically less developed country" for the purposes of the provisions with respect to controlled foreign corporations.[68] The code goes on to provide that no such designation shall be made in respect of some twenty-one specifically named countries, *e.g.*, Australia, France, Japan, Monaco, United Kingdom, etc. but including only Canada of the Western Hemisphere countries.

In discussing one particular phase of the administration of the new provisions relating to foreign controlled corporations, *i.e.*, the policy for issuing rulings under section 367 with respect to reorganization of foreign corporate structures, the Conference Committee said: "The conferees recognize that the problems in this area are complex and that particular aspects of the policy . . . may require qualification and refinement as experience is gained in applying it to particular situations."[69] This statement could be applied to the entire subpart F relating to controlled foreign corporations. The provisions of the subpart are complex; they alter substantially the scheme for taxing income from foreign corporations. Domestic corporations with foreign subsidiaries have had to reconsider and re-evaluate existing corporate structures and procedures, and it will be years before clearly defined lines are drawn in this area of our tax laws.

8. Gains from Disposition of Depreciable Property. Another departure from previous tax rules was effected by Section 13 of the Revenue Act of 1962. That section added to the Internal Revenue Code new section 1245, which, in general, provides for treating as ordinary income the gain realized upon the disposition of certain depreciable property to the extent of depreciation deductions taken in 1962 or subsequent years. Under prior law a taxpayer, who by reason of calculations based on too short a useful life or by reason of the particular method of depreciation allowing depreciation deductions in excess of actual decline in value, realized gain on the sale of a depreciable asset, effectively converted ordinary income into

[68] IRC, § 955(c)(3). See Exec. Order No. 11071, 27 Fed. Reg. 12875 (1962). The only nation in the western hemisphere not considered less developed for the purposes of the Revenue Act of 1962 is Canada.

[69] H.R. REP. No. 2508. 87th Cong., 2d Sess., 35 (1962).

capital gain. This resulted from depreciation deductions reducing ordinary income while the gain was taxed as capital gain. Having in mind liberalized depreciation allowances and the recommendation for an investment credit with respect to newly acquired property, the President's position was "that our capital gains concept should not encompass this kind of income" and that "this inequity should be eliminated."[70] While the enactment is not as broad as the President recommended and while certain dispositions are excepted from the rule—buildings and their structural components will continue to be free of the recapture provision—it will curb to a considerable extent the possibility of converting ordinary income into capital gains by disposition of depreciable property.

9. Foreign Investment Companies. According to the congressional committees[71] an increasing number of taxpayers in recent years have sought to avoid U.S. taxes by investing in foreign rather than domestic investment companies. The foreign investment companies, having followed announced policies of reinvesting all income in stocks and bonds, have paid little or no dividends, and therefore the U. S. stockholders have paid little or no taxes with respect to their investment in such companies until they sold their stock. Then the gain realized on the sale was taxable as capital gain. Section 14 of the Revenue Act of 1962 adds new sections 1246 and 1247 to the Internal Revenue Code, which, in general, tax American stockholders on their share of any earnings and profits accumulated in a foreign investment company after December 31, 1962, or since acquisition of their stock if that is later, as ordinary income rather than capital gains. This result can be avoided if the foreign investment company elects and currently distributes ninety per cent of its taxable income other than net long-term capital gain and informs its U. S. stockholders of their share of any net long-term capital gains. The U. S. stockholder, of course, is required to include in his income his share of the net long-term capital gains as well as the distribution of ordinary income, just as he already is required to do with respect to domestic investment companies. The enactment of sections 1246 and 1247 is another indication of the constantly narrowing of opportunity to realize long-term capital gains rather than ordinary income.

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[70] S. Rep. No. 1881, 95.

[71] H.R. Rep. No. 1447, 72; S. Rep. No. 1881, 101.

10. Gain from Disposition of Stock in Foreign Corporations. As another facet of the objective of imposing full U. S. taxation when income earned abroad is repatriated,[72] Congress added new section 1248 to the code. That section provides that, where a U. S. stockholder owns ten per cent or more of the voting stock of a foreign corporation, gain recognized on the sale or exchange of his stock shall be included in his gross income as a dividend to the extent of the foreign corporation's earnings and profits attributable to the period the stock was held by him while the foreign corporation was a "controlled foreign corporation." For this purpose any foreign corporation is a "controlled corporation" if more than one-half of the total combined voting power of all classes of voting stock is owned (directly or constructively) by United States stockholders on any one day during the corporation's taxable year.[73] If the gain is not recognized, section 1248 does not apply; but if the section applies, unless the taxpayer can establish the earnings and profits taxable to him, his entire gain on the sale or exchange is considered a dividend. There is a limitation on the tax payable by an individual[74] and special rules are provided for determining the earnings and profits of the foreign corporation for these purposes.[75]

11. Sale of Patent, Invention, or Copyright. Section 16 of the Revenue Act of 1962 adds new section 1249 to the code. Under this section gain from the taxable sale or exchange of patents, inventions, models or designs, copyrights, secret formulas or process, or other similar property rights, after December 31, 1962, to a foreign corporation by a U. S. person controlling that corporation is to be treated as ordinary income rather than capital gain. Here again control means more than fifty per cent of the total combined voting power of all classes of stock entitled to vote.

12. Cooperatives and Their Patrons. Section 17 of the new act added new subchapter T, relating to cooperatives and their patrons, to the income tax provisions of the code. Subchapter T consists of several sections which, in brief, provide that cooperative corporations and exempt farmers' cooperatives are not required to take patronage dividends paid in money, qualified allocations, or other property (except unqualified allocations) into account in deter-

[72] H.R. REP. No. 1447, 76.
[73] IRC, § 957(a).
[74] IRC, § 1248(b).
[75] IRC, § 1248(c).

mining their taxable income,[76] and that the same amounts (to a limited extent) are includible in the patron's taxable income for the year in which received or redeemed.[77] The intent of subchapter T was to accomplish what Congress thought was done in 1951, *i.e.,* to tax currently the earnings of cooperatives from business activity either to the cooperatives or to their patrons.[78] Because certain court decisions held non-cash allocations of patronage dividends were not taxable to patrons, although deductible by the cooperative,[79] subchapter T was enacted, substantially along the lines requested by the President. Cooperatives are now allowed to deduct amounts allocated in cash or scrip as patronage dividends, but taxing patrons currently on the same items.[80]

13. Foreign Real Estate—Estate Tax. Under the law prior to the enactment of the Revenue Act of 1962, real estate situated outside the United States was excluded from the gross estate of a decedent and therefore not subject to federal estate tax.[81] Recognizing indications of abuse, *i.e.,* persons acquiring foreign real estate to avoid estate tax, Congress amended the law to include foreign real estate in determining the taxable estate of a deceased citizen or resident of the United States. Thus, effective with respect to estates of decedents dying after October 16, 1962, foreign real estate must be included in the gross estate at market value.

14. Information Returns—Dividends and Interest. Section 19 of the Revenue Act of 1962 amends several sections of the code relating to the reporting of income payments and to penalties for failure to furnish information required. The House of Representatives enacted provisions requiring payors of interest, dividends, and patronage dividends to withhold income tax at the rate of twenty per cent.[82] The Senate substituted provisions requiring such payors to file information returns with respect to payments to any person aggregating ten dollars or more in the calendar year and to furnish the recipient an

[76] IRC, § 1382.
[77] IRC, § 1385.
[78] H.R. Rep. No. 1447, 78.
[79] See Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726 (4th Cir.), *reversing* 27 T.C. 985 (1957), and B.A. Carpenter v. Commissioner, 219 F.2d 635 (5th Cir. 1955), *affirming* 20 T.C. 603 (1953).
[80] S. Rep. No. 1881, 111.
[81] IRC, § 2031(a).
[82] H.R. 10650, 87th Cong., 2d Sess. (1962) (by vote of 219 to 196).

annual statement showing the amount reported to Internal Revenue Service.[83] In its report the Senate Finance Committee said:

> Your committee has studied at length the system provided by the House bill for withholding on dividends, interest and patronage dividends. In addition, it has considered numerous alternative withholding provisions. It is convinced after this analysis, however, that the provision in the House bill, as well as the alternatives, are neither simple in operation nor free of substantial hardship for broad groups of taxpayers. Furthermore, it represents a heavy administrative burden for the businesses which would have to perform the withholding and collecting functions for the Government. It also appears that there are numerous tax avoidance possibilities in a system providing exemption certificates and intra-annual refunds.
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> . . . .
>
> Despite the shortcomings of a system for withholding on dividends, interest, and patronage dividends, your committee strongly endorses the concept that everyone must pay his full share of the income tax liability. Moreover, it recognizes that the underreporting of dividends and interest on tax returns is a serious problem which needs correction. However, it has concluded that an improved reporting system is preferable to provision for withholding.
>
> While it may be difficult initially to provide a full matching of information and tax returns, the extended use of automatic data processing, together with the accounting number system provided for in legislation enacted last year, should quite soon make it possible to provide for a full matching of these information and tax returns.[84]

When the House agreed to go along with the Senate, provisions were enacted which require every person paying dividends,[85] interest,[86] or patronage dividends,[87] aggregating ten dollars or more to any person during a calendar year to file information returns with

[83] H.R. 10650, 87th Cong., 2d Sess. (1962) (by vote of 59 to 24).
[84] S. Rep. No. 1881, 118-19.
[85] IRC, § 6042.
[86] IRC, § 6049.
[87] IRC, § 6044.

Internal Revenue Service and to furnish statements thereof to the recipients of the payments. In addition penalties are imposed for failure to file or furnish the information required.[88]

While the law says "every person" making these payments must file information returns, due to definitions (*e.g.*, interest) and exceptions (*e.g.*, foreign corporations), not every payment is to be reported. However, the payments normally associated with dividends (domestic corporation paying) and interest (bank or building and loan association paying on savings account) must be reported. These requirements are effective with respect to payments of dividends and interest on or after January 1, 1963, and of patronage dividends on or after that date with respect to patronage on or after the first day of the first taxable year of the cooperative beginning on or after January 1, 1963.[89]

B. Self-Employed Individuals Tax Retirement Act of 1962

The second most significant tax legislation enacted in 1962 was the Self-Employed Individuals Tax Retirement Act of 1962.[90] This act made fairly extensive amendments to the code intended to permit self-employed persons to establish and participate in retirement plans on a basis generally similar to that available to employees. In brief, employees participating in employer-established pension, profit-sharing, and other qualified plans are not taxed currently on employer contributions or income from investments. Generally benefits of these plans are taxed only when received, and some benefits then are taxed at favorable long-term capital gains rates rather than at ordinary income rates.[91]

Probably the real significance in the enactment of the Self-Employed Individuals Tax Retirement Act lies in the fact of enactment itself, rather than in the actual provisions of the act. While the intent had been to place self-employed individuals on a basis comparable to employees, the ultimate result fell short of the mark. There may be some self-employed individuals who can utilize this new legislation economically and effectively, thereby achieving a status comparable to that of employees, but the number will not be great.

[88] IRC, §§ 6652, 6678.
[89] Revenue Act of 1962, § 19(h), 76 Stat. 1058 (1962).
[90] Pub. L. No. 87-792, 87th Cong., 2d Sess. (Oct. 10, 1962).
[91] IRC, § 402(a).

Because of the limitations and requirements imposed, it is doubted that this law will be very useful in its present form.

With this law enacted after years of consideration, why will so few self-employed individuals *utilize* it? The requirements and limitations render it largely impracticable. The primary draw-backs to the self-employed person can be stated briefly: (1) Deduction is limited to fifty per cent of the total contributions for the self-employed individuals; (2) The self-employed individual's plan must cover all his employees (except part-time and seasonal workers) having more than three years service; and (3) Long-term capital gains treatment is not allowable.

In addition to the limitation on the deduction, there is an over-all limitation restricting the deduction to fifty per cent of 2,500 dollars or ten per cent of earned income, whichever is less. Thus, the maximum annual deduction for contributions for the self-employed individual is 1,250 dollars. Earned income includes professional fees and other compensation for personal services. If both personal services and capital are combined to produce the income, "earned income" means not more than thirty per cent of the income from the business, but not less than 2,500 dollars where the self-employed individual works full time. These limitations on deduction do not apply with respect to contributions for employees, but, of course, limitations already in the code control such deductions.

The basic concept of this legislation is to consider the self-employed individual as the employer of himself, and having considered him as an employee, to utilize most of the provisions and procedures applicable to employee plans generally in order to permit him to participate in a qualified plan. The rules generally applicable to such plans must be met, as well as the more stringent ones imposed by the Self-Employed Individuals Act. For instance, contributions for an employee must be unforfeitable at the time made. The plan may not exclude any employee with three years' service. Except in case of early death or disability, benefits cannot be made available to the self-employed individual before age fifty-nine and one-half, but they must be made available to him by the time he is seventy and one-half. These rules are "tighter" than those generally applicable to employee benefit plans, but are considered "essential in order to prevent retirement plans of owner-employees from becoming purely

income-averaging devices and to insure that contributions made for their employees do not inure to the benefit of owner-employees."[92]

This law permits the self-employed person or his plan to: (1) Deposit contributions with a bank as trustee, or as custodian if the contributions are invested in the stock of an "open-end" regulated investment company or insurance policies; (2) Invest contributions in nontransferable annuities with an insurance company or in nontransferable face amount certificates; or (3) Invest contributions in a new series of U. S. Government bonds (nontransferable, nonredeemable before age fifty-nine and one-half).

Even though the Senate Finance Committee said this legislation "is designed to encourage the establishment of voluntary retirement plans by self-employed persons"[93] and noted that more "than 7 million self-employed persons who pay income taxes would be permitted to establish retirement plans"[94] under the legislation, it is unlikely that many self-employed persons will establish and maintain plans under these rules. Thus, even though the American Bar Association and other groups have worked for at least ten or eleven years to obtain legislation to allow self-employed individuals to set up qualified plans, about all one can say realistically is that the law is on the books. One writer has mentioned this law as "a motley measure authorizing a semblance of qualified retirement plans for self-employed persons."[95]

While the Self-Employed Individuals Tax Retirement Act is far from ideal, there nevertheless is merit in it. Though the amount on the books be little, better days lie ahead for the self-employed. Congress will begin revising this "motley measure" to bring it closer to the intent and purpose of the legislation. These provisions, enacted over the continuing opposition of the administration, represent a major step forward in this area of our tax law.

II. THE PRESIDENT'S TAX PROPOSALS FOR 1963

In delivering to Congress his State of the Union Address on January 14, 1963, the President said "the enactment this year of a substantial reduction and revision in Federal income taxes" is

[92] Self-Employed Individuals Tax Retirement Act of 1961, S. REP. No. 992, 87th Cong., 1st Sess. 2 (1961) [hereinafter cited as S. REP. No. 992].

[93] S. REP. No. 992, 1.

[94] S. REP. No. 992, 3.

[95] MERTENS, LAW OF FEDERAL INCOME TAXATION, CODE COMMENTARY 111 (Supp. 1962).

essential. In his Special Message on Tax Reduction and Reform, delivered to Congress on January 24, 1963, the President spelled out some of his tax proposals for reduction and revision.

The President recommended as to reductions: (1) Reduction of individual tax rates over a three year period from the present levels of twenty to ninety-one per cent to fourteen to sixty-five per cent, with the fourteen per cent rate to apply to the first 2,000 dollars of taxable income in the case of married taxpayers filing joint returns and to the first 1,000 dollars of taxable income of single taxpayers; (2) Reduction of the corporate income rates over a three year period from fifty-two per cent to forty-seven per cent; and (3) Reversal of the corporate normal and surtax rates, so that the rate imposed on the first 25,000 dollars of corporate income is reduced from thirty per cent to twenty-two per cent.

As to revision, the President recommended: (1) Acceleration of tax payments by corporations with anticipated annual liabilities over 100,000 dollars, to bring the corporate payment schedule to a current basis over a five year period; (2) Revision of the treatment accorded capital gains, to provide a "freer and fuller flow" of capital funds and to achieve greater equity; (3) Removal of certain inequities and hardships in our tax structure; and (4) Broadening of the base for individual and corporate income taxes, "to remove unwarranted special privileges, correct defects in the tax law, and provide more equal treatment of taxpayers—thereby permitting a larger reduction in tax rates than would otherwise be possible and making possible my proposals to alleviate hardships and inequities."[96]

Considering present treatment of capital gains and losses as "both inequitable and a barrier to economic growth," the President recommended that only thirty per cent of long-term capital gains be taxed (with the maximum rate being nineteen and one-half per cent instead of twenty-five per cent) but that the minimum holding period to qualify for long-term treatment be increased from six to twelve months. To remove inequities and hardships the President recommended among other things, some income averaging, liberalized charitable contribution deductions, repeal of sick pay exclusions, repeal of dividends received credit and exclusion, and limitation on

[96] President Kennedy's Special Message on Tax Reduction and Reform, January 24, 1963, appearing in The Wall Street Journal, Jan. 25, 1963, p. 10.

deduction for itemized deductions to only that part of the deductions in excess of five per cent of adjusted gross income.

The "reductions" proposed when fully effective beginning January 1, 1965, would reduce revenues by 13.6 billion dollars annually, but the "revisions" would add 3.4 billion dollars, the combined result being a net reduction of 10.2 billion dollars. The President recognized "that the largest single barrier to full employment of our manpower and resources and to a higher rate of economic growth is the unrealistically heavy drag of Federal income taxes on private purchasing power, initiative and incentive."[97] He also said "Larger cuts would create a larger budget deficit and the possibility of renewed inflationary pressures."[98] On the other side of the ledger, he said "It would be a grave mistake to require that any tax reduction today be offset by a corresponding cut in expenditures."[99]

Close study of the President's proposals reveals a studious effort to please that one person who more than anyone else can determine the fate of the proposals, the Hon. Wilbur D. Mills, Congressman from Arkansas and Chairman of the Ways and Means Committee. For many years Mr. Mills has championed tax reform and does not favor reduction without reform.[100] Politically, of course, reduction without reform would be ideal. Tax reduction which is admittedly needed is popular; however, tax reform which if realistically done must hurt some taxpayers is not so popular and is outright heresy to those who would be hurt. In his January 24, 1963 Special Message, the President said "Tax reduction and structural reform should be considered and enacted as a single intergrated program."[101] The influence of Mr. Mills' thinking was obvious.

The public reaction to the President's proposals has not enhanced the possibility of their enactment. Quite naturally widespread support for rate reductions has been indicated; however, much of that support is conditioned on comparable reductions in expenditures. It has been apparent that many Americans feel that tax rate reductions should be made only on a basis commensurate with reductions in expenditures. In its lead editorial of February 11, 1963, the *Wall Street Journal* wrote, "a lot of us are indeed afflicted with

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[97] *Ibid.*
[98] *Ibid.*
[99] *Ibid.*
[100] Time, Jan. 11, 1963, pp. 19-22.
[101] *Ibid.*

what Economic Adviser Heller scoffingly calls the Puritan ethic. Federal spending soaring to nearly $100 billion looks improvident enough; in addition, deliberately lowering revenues to help make a $12 billion deficit does rather offend our sense of financial propriety."[102] In the March 1963 issue, *Fortune* magazine's lead editorial is "How to Save the Tax Cut." *Fortune* says:

> Unless Congress wakes up . . . we are likely to get merely a haphazard mutilation of the Kennedy tax plan. . . . it is now clear that public desire for tax cuts is not strong enough to overcome the public's fear of huge budget deficits stretching into the indefinite future. A politically smart Kennedy may have misread the public feelings about deficits, and as a result his tax proposals may be beaten, or mauled out of all recognition.[103]

It is not just the business-oriented press that is voicing opposition to the President's proposals. A relatively small, but good, weekly newspaper recently entitled its editorial "Tax Cut, Tax Reform," and among other things said:

> For the first time in history, this government is setting up a planned deficit financing program for at least ten years ahead. It is inconceivable that the American people and their representatives in Congress will go along with a policy that invites inevitable disaster. The encouraging fact is that the American people are waking up to the dangers of Mr. Kennedy's program and are registering vigorous protests both on the national and the 'grass roots' level.[104]

Because of increasing oppositon to reductions at the cost of further increases in the deficit, and because of widespread opposition to some of the reforms proposed, the President's tax program now stands in serious trouble and is doubtful of enactment. In fact the President himself appears to acknowledge this fact. He recently indicated that he would accept a total tax cut of ten billion dollars over a three year period without any reforms.[105] This has been interpreted as a "junking" of the reform part of his program. Congressional

[102] The Wall Street Journal, Feb. 11, 1963, p. 14, col. 1.
[103] Fortune, March 1963, pp. 79-80.
[104] The Hartsville Messenger, Feb. 21, 1963, p. 2B, col. 1.
[105] The Wall Street Journal, Feb. 27, 1963, p. 32.

reaction to the President's concession has varied widely, with those congressmen favoring rate reductions without regard to reforms being quite pleased but with those favoring reform along with rate reductions being somewhat bitter. With the Chairman of the Committee on Ways and Means strongly committed to the philosophy of reforms coupled with reductions, it now is highly questionable as to what, if any, major tax legislation will be enacted in 1963.

III. Administrative Developments

The administrative developments in the field of federal taxation during the past few months are too numerous to catalogue. Of particular significance are the new depreciation rules and the use of the identifying account numbers in conjunction with Automatic Data Processing.

A. New Depreciation Rules

The administrative promulgation of new depreciation guidelines and rules[106] was far and away the most significant administrative development. The mere prospect of this bore influence even before the promulgation, and of course the new rules will influence tax computations, planning, and liability for many years.

For many years Bulletin F,[107] the old "guide" as to depreciation allowances, had been under severe and continuing attack on the grounds that it specified useful lives that were too long. While the Bulletin F rates were not mandatory per se, as a practical matter taxpayers were "on the defensive" to substantiate more realistic rates. In issuing Revenue Procedure 62-21, the Treasury Department stated in a press release:

> The fundamental concept underlying the new Procedure is that the depreciation claimed by a taxpayer will not be disturbed if there is an overall consistency between the depreciation schedule he uses and his actual practice in retiring and replacing his machinery and equipment. Demonstration of this overall consistency will be based upon broad classes of assets. Guidelines are established for each of these classes—in all cases shorter than those previously suggested for the

[106] Rev. Proc. 62-21, 1962 Int. Rev. Bull. No. 30, at 6.
[107] 2 CCH 1963 Stand. Fed. Tax Rep. ¶ 1777.

guideline class as a whole—to assist in the determination of appropriate depreciable lives.[108]

Revenue Procedure 62-21 became effective with its promulgation and taxpayers thereafter filing returns could apply the new, shorter useful lives in determining their depreciation allowances. While Rev. Proc. 62-21 replaced Bulletin F as to depreciable lives of assets, the new procedure did not supersede existing rules, outstanding arrangements, or established procedures where taxpayers wish to continue using them.

The new guidelines are available at the taxpayer's option. If he elects to use them, he may do so without challenge for the first three years. But beginning with the fourth year under Rev. Proc. 62-21 his use of the new lives may be questioned if application of the reserve ratio test under the procedure indicates that the taxpayer is not approaching a replacement practice consistent with the class life used for tax purposes.

In general Rev. Proc. 62-21 sets out "guideline lives" for about seventy-five broad classes of asets. Some classes cut across industry lines (*e.g.*, group one (1), office furniture, fixtures, machines and equipment), but others cover all production machinery and equipment typically used by an industry (*e.g.*, group three (1) manufacturing, aerospace industry). Thus, in most cases a taxpayer under the new procedure can determine his depreciation allowance with reference to only three or four guidelines while under Bulletin F, he might have had reference to a great number of item-by-item guides.

To some extent this represents simplification, but this is about all the simplification to be found in the procedure. Overall, the procedure is not simple; in its entirety it is quite complex. This is demonstrated by the great lengths to which the Treasury Department has gone to clarify and explain the procedure. Some forty-two questions and answers were published[109] with the procedure, and subsequently, the Department issued additional questions (forty-three through fifty-nine) further explaining Rev. Proc. 62-21.[110]

Contact so far with taxpayers, accountants, and others indicates

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[108] Treas. Dept., D-538 (for release at 6:30 PM (EDT), Weds., July 11, 1962).

[109] Rev. Proc. 62-21, 1962 INT. REV. BULL. No. 30, at 39-50.

[110] 1962 INT. REV. BULL. No. 40, at 33-45.

considerable reluctance to use this new procedure. While taxpayers want to use shorter asset lives, they and their advisors are awed to some extent by the over-all application of the procedure. It must be recognized, however, that in reality they have little choice because after three years revenue agents will be oriented in the procedure and no doubt in one way or another will apply it in most cases. In other words, Rev. Proc. 62-21 is with us, and we must use it sooner or later. But have hope; when issuing it, the Treasury Department said:

> The new Procedure, overall, will provide more realistic and more uniform treatment of depreciation. It will protect taxpayers from frequent adjustments in depreciation rates and will minimize needless controversy over the timing of the recovery of the cost of investment.
>
> The experience under the new guideline lives, industry and asset classifications and administrative procedures will be watched carefully with a view to possible corrections and improvements. Periodic reexamination and revision will be essential to maintain tax depreciation treatment which is in keeping with modern industrial practices.[111]

B. Identifying Account Numbers—Automatic Data Processing

Among the many other recent administrative developments, one other should be mentioned—the promulgation of T.D. 6606.[112] That Treasury Decision provides regulations under sections 6109 and 6676 of the code, relating to the use and furnishing of identifying account numbers. Recognizing that a number system was mandatory to realize the full advantages of Automatic Data Processing (ADP), Congress added those sections to the code in 1961.[113]

While taxpayers will continue to show their names on their returns, the primary identification hereafter will be their "account number." The taxpayer's "account number" and his Social Security number are the same. Persons not having Social Security numbers have been or will be given numbers. An individual filing a return, statement, or other document after September 30, 1962, with respect

[111] IRS Publication No. 456 (7-62), at 7.
[112] 1962 INT. REV. BULL. No. 39, at 12-35.
[113] Pub. L. No. 87-397, 87th Cong., 1st Sess. 1961; 1961-2 CUM. BULL. 348.

to income tax liability for any period beginning after 1961, must show his account number on the return or document.[114] Likewise, if it is an employer filing the return or document, the employer's identification number must be shown. This is not a Social Security number but is a number assigned to and required of employers subject to wage withholding or to payment of excise taxes. Some individuals of course have both a Social Security number and an employer's identification number; and if such a person is engaged in a trade or business (and thereby completes schedule C or F of the return form), he will show both numbers on his return.

In addition to requiring the taxpayer to show the appropriate number in his tax return and other related documents the law and regulations require persons making certain payments (wages, dividends, etc.) to include the payee's account number as information and other returns.[115] That person is authorized to request the payee for his number and the payee must furnish it or suffer the penalties of the statute.[116]

The real significance in T.D. 6606 does not lie in the Treasury Decision itself, but in the indicated implementation of the service's Automatic Data Processing program or system. ADP, as it commonly is called, is a fact. With modern electronic equipment, the service already is processing tax returns and related documents in some regions, and within a very few years will have the system operating throughout the fifty States. The Atlanta region was the first to go on ADP, and, according to service officials was chosen as the first because, after close analysis, it was decided that that region, more than any other, would provide a wider variety of typical situations and consequences applicable to the entire country.

Without attempting to go into great detail, some of the possibilities of ADP should be briefly noted. (1) Determination can be made almost instantly as to whether a person filed a return, filed a claim for refund, owes taxes, or is entitled to a credit or refund. (2) Verification of mathematical accuracy of returns and tax computations can be made almost instantly. (3) With a magnetic tape containing 100,000 "master files" (a consolidated tax account for each of the 100,000 taxpayers), the current status at any given time

[114] Treas. Reg. § 1.6109-1(b)(1)(i) (1962); T.D. 6606, Aug. 24, 1962.
[115] IRC, § 6109.
[116] IRC, § 6676.

for the 100,000 can be read in four and one-half minutes. From the foregoing the possibilities appear stunning. For instance, when ADP is operating throughout the states, the service, by reading its "master files" can check on eighty million tax returns in three days! Without ADP it would be impossible to check all those returns. Thus, with ADP working taxpayers and tax advisors should anticipate examination of returns and more frequent adjustments to taxable income. It is clear that the only person who will be hurt by ADP under normal conditions will be the cheater.

In recent years industry has achieved astounding results by the utilization of electronic data processing in revamping its operations and procedures. Now the government has taken steps to modernize its tax collecting "industry." This is something which should be expected, and overall it is healthy for the country and taxpayers generally, even though some people will pay additional taxes. In any event the promulgation of T.D. 6605 represents the implementing step of a significant development—Automatic Data Processing.