DIARY

Book 175

Suggested Tax Adjustments Designed

to Reduce Deterrent Effects on Business: March 1939

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SUGGESTED TAX ADJUSTMENTS DESIGNED TO REDUCE DETERRENT EFFECTS ON BUSINESS

1. Net loss carry-over for individuals and corporations.

History. For a number of years prior to 1934 taxpayers were allowed to carry forward net losses incurred in trade or business and to use them as deductions in later years. In the Revenue Act of 1928 such losses were allowed to be carried forward for two years. The Revenue Act of 1932 cut down the carry-over to one year and the National Industrial Recovery Act of 1933 eliminated it entirely. It has not been in effect since, except that in the 1938 Act a one-year net loss carry-over was allowed to corporations but only as a credit for purposes of the 2½ percent undistributed profits tax.

Proposal. Allow net losses of business, both individual and corporate, to be offset against the business income of the succeeding year. Any loss not absorbed by the income of the succeeding year could be carried forward to the following two years in the same manner.

2. Exemption of dividends from individual normal tax.

History. Prior to 1936 dividends received by individuals were subject only to surtaxes. The 1936 Act subjected dividends to both normal tax and surtax.

Proposal. Allow dividends that are received by individuals from domestic corporations subject to Federal income taxation to be credited against net income in computing the normal tax. Such dividends would be subject to surtax as at present.

3. Elimination of tax on intercorporate dividends.

History. Prior to 1936 the entire amount of dividends received by corporations was deducted from gross income to avoid multiple taxation of corporate earnings. Under the present law 85 percent of such intercorporate dividends are deductible, the remaining 15 percent being taxable.

Proposal. Allow all dividends received by a corporation from a domestic corporation which is subject to Federal income taxation to be deducted from gross income.

4. Restoration of consolidated returns.

History. Closely affiliated corporations were permitted to file consolidated returns prior to 1934, although beginning in 1932 an increased rate was imposed for the privilege of filing such returns. The permission was withdrawn by the Revenue Act of 1934 and consolidated returns are now permitted only in the case of railroad corporations.

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Proposal. Restore the privilege of filing consolidated returns without penalty. This privilege would necessarily be accompanied by the elimination of the tax on intercorporate dividends previously mentioned. The privilege of consolidation would be limited to closely (95 percent) affiliated corporations along the lines followed in earlier laws.

5. Elimination of the limitation on deduction of corporate capital losses.

History. Prior to 1934, corporations were permitted to deduct capital losses from ordinary income without limitation. The Revenue Act of 1934 provided that any excess of capital losses over capital gains could be deducted from ordinary income only up to $2,000.

Proposal. In the case of industrial corporations, permit capital losses to be deducted in full from ordinary income. In the case of other corporations, either (1) limit the deduction to $2,000 ordinary income, or (2) permit a carry-forward of net capital losses against capital gains of future years.

6. Repeal of capital stock and excess profits taxes.

History. The existing capital stock and excess profits taxes were placed in the law by the National Industrial Recovery Act of 1933. New declarations of the value of capital stock were provided by the Revenue Acts of 1934, 1935, as amended in 1936, and 1938.

Proposal. Repeal the capital stock and excess profits taxes. The repeal of the capital stock tax would be effective for years beginning after June 30, 1939. Repeal of the excess profits tax would be effective for the first income year ending after June 30, 1940.

7. Repeal of undistributed profits tax and introduction of new rate schedule.

History. Prior to 1936 flat tax rates were applied in taxing the income of corporations, the rate under the Revenue Act of 1934 being 13¾ percent. The Revenue Act of 1936 provided progressive rates ranging up to 15 percent on income over $40,000 and imposed a separate tax of 7 to 27 percent on undistributed profits. The Revenue Act of 1938 provided graduated taxes for corporations with incomes under $25,000 and a basic rate of 16½ percent plus an undistributed profits tax of 2½ percent in the case of corporations with incomes of over $25,000. Special classes of corporations are taxed at 16½ percent.

Proposal. Replace the present corporate tax rate structure by a tax of 17 percent on the net income of corporations having incomes of not more than $25,000 and 20 percent on the income of corporations having net incomes of over $25,000. Special "notch" provisions would

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be included applying to corporations with incomes of slightly over $25,000 so that such corporations may not have less income after taxes than corporations with incomes of under $25,000. Corporations falling in the flat rate classes in the present law would either be taxed at the 20 percent rate or treated as all other corporations.

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Table 6

BOOK SHAREHOLDERS AND SHAREHOLDINGS IN 1,265 CORPORATIONS
ON OR ABOUT DECEMBER 31, 1937

Classified by Size of Corporation

Assets ($ million)	Number of corporations	Number of shareholders	Shares outstanding	Market value of shares outstanding (000 omitted) 1/	Market value of average shareholding 1/	Holdings of 100 shares or less: Holders: Number	Holders: Percent of total	Shares: Number	Shares: Percent of total	Market value 1/: Amount (000 omitted)	Market value 1/: Percent of total
Under 1	197	201,968	99,070,393	$ 213,692	$ 1,058	143,222	70.9	6,606,518	6.7	$ 32,263	15.1
1 and under 5	399	610,302	140,666,974	788,180	1,291	476,603	78.1	18,903,583	13.4	136,379	17.3
5 and under 10	192	517,985	84,255,231	966,318	1,866	433,145	83.6	15,097,935	17.9	189,818	19.6
10 and under 20	173	702,323	117,027,796	1,679,848	2,392	590,114	84.0	19,942,149	17.0	284,104	16.9
20 and under 50	140	970,096	142,402,351	2,590,505	2,670	830,780	85.6	26,137,143	18.4	474,268	18.3
50 and under 100	62	758,131	107,359,021	2,886,175	3,807	629,218	83.0	18,946,283	17.6	456,421	15.8
100 and under 200	42	1,122,670	134,603,491	4,090,076	3,643	975,461	86.9	27,423,487	20.4	851,100	20.8
200 and under 500	32	1,038,741	123,536,774	3,133,490	3,017	904,447	87.1	25,465,708	20.6	629,506	20.1
500 and over	28	2,219,773	250,849,436	7,730,510	3,483	1,961,125	88.3	46,636,881	18.6	2,163,729	28.0
Total	1,265	8,141,989	1,199,771,467	24,078,794	2,957	6,944,115	85.3	205,159,687	17.1	5,217,588	21.7

1/ Based upon last sale price on December 31, 1937, or upon the average of the bid and asked prices on that date if no sales were consummated and if the bid and asked range was reasonable; otherwise, upon the sale price nearest December 31, 1937.

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Table 12

BOOK SHAREHOLDERS AND SHAREHOLDINGS IN 244 "CLOSELY HELD" CORPORATIONS
ON OR ABOUT DECEMBER 31, 1937

Classified by size of Corporation

Assets ($ Millions)	Number of Corporations	Number of Shareholders	Shares Outstanding	Market Value of Shares Outstanding 1/ (000 omitted)	Market Value of Average 1/ Shareholding	Holdings of 100 Shares or Less: Holders: Number	Holders: Percent of total	Shares: Number	Shares: Percent of total	Market Value 1/: Amount (000 omitted)	Market Value 1/: Percent of total
Under 1	49	19,929	50,855,413	$ 12,637	$ 634	9,969	50.0	500,831	1.0	$ 834	6.6
1 and under 5	74	54,442	48,990,780	126,469	2,323	40,510	74.4	1,664,366	3.4	10,644	8.4
5 and under 10	32	33,406	13,569,899	129,760	3,884	27,990	83.8	1,022,577	7.5	8,051	6.2
10 and under 20	25	33,037	13,926,012	126,736	3,836	28,250	85.5	911,509	6.5	9,804	7.7
20 and under 50	30	59,469	20,206,777	255,786	4,301	51,058	85.9	1,545,246	7.6	20,563	8.0
50 and under 100	12	106,154	10,195,585	197,343	1,859	103,371	97.4	896,293	8.8	14,246	7.2
100 and under 200	13	25,724	20,121,237	292,601	11,375	20,544	79.9	735,198	3.7	11,664	4.0
200 and under 500	7	49,436	23,514,230	696,487	14,089	44,071	89.1	1,100,902	4.7	54,196	7.8
500 and over	2	19,286	3,673,774	18,447	956	17,533	90.9	494,049	13.6	2,394	13.0
Total	244	400,883	205,053,707	1,856,266	4,630	343,296	85.6	8,875,971	4.3	132,396	7.1

1/ Based upon last sale price on December 31, 1937, or upon the average of the bid and asked prices on that date if no sales were consummated and if the bid and asked range was reasonable; otherwise upon the sale price nearest December 31, 1937.

Regraded Unclassified

Elimination of intercorporate dividend tax 1
Elimination of dividends received from taxable income of corporations.

Repeal of undistributed profits tax 2

Exemption of dividends from individual normal tax 3

Net loss carry-over 4
Net loss carry-over for individuals and corporations.

Corporate capital losses 5
Elimination of limitation on allowances of corporate capital losses so that such losses may be taken in full.

Capital stock and excess-profits tax repeal 6

Consolidated returns 7
Restoration of consolidated returns for all affiliated corporations.

Assumption of indebtedness 8
New provisions dealing with the effect of assumptions of indebtedness in connection with reorganizations and other tax-free exchanges under section 112.

Cancellation of indebtedness 9
Revision of the law with respect to cancellation of indebtedness.

Stock dividends 10
Provision establishing the treatment of the basis of stock dividends both in the future and retroactively to terminate the confusion which has resulted from the Koshland and Gowran cases.

Stock rights 11

Inventories--last-in first-out 12
Revision of section 22(d), which provides for the use of the last-in, first-out method of valuing inventories.

Mortgage foreclosures 13
Express provision with respect to the treatment of mortgages and other liens and foreclosures.

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Mutual insurance companies 14
Revision of the provisions for taxation of mutual life insurance companies other than life.

Section 820 of the Revenue Act of 1938 15

Personal holding company deficits 16
Provision for some form of deficit cushion to allow a credit against undistributed personal holding company net income where corporation has no earnings or profits.

Foreign tax credit 17
Amendment to the foreign tax credit provision to give proper credit for intercorporate dividends received and Federal bond interest.

Deputy collectors--civil service 18
Legislation bringing deputy collectors of internal revenue within the Civil Service and extending to them the benefits of the Retirement Act.

Donees' depreciation basis 19
Provision that basis of donees for depreciation shall be the same as basis for determination of loss.

Publicity of returns 20
Repeal of section 148(f) relating to publicity of names and salaries of corporate officers.

Copper tax elimination 21
Repeal of the 4 cents per pound tax on imported copper.

Estate valuation option 22
Elimination or clarification of estate valuation option (section 811(j)) with particular reference to interest, rents and dividends received by the estate between the date of decedent's death and the valuation date.

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Insolvent banks 23
Amendment of an Act passed in 1879 (as amended in the Revenue Act of 1938) relating to the remission of taxes due from insolvent banks to eliminate any hardship which may result from the present provision which permits collection of such taxes immediately after depositors have been paid in full.

Control in reorganizations 24
Definition of control with respect to tax-free reorganizations.

Final settlement of judgments by Commissioner 25
Authority of the Commissioner to make final settlement of judgments for overpayment of taxes.

Embezzlement losses 26
Provision for allowance of deductions for losses from embezzlement in the year of its discovery rather than the year when it occurs when its existence is often unknown.

Banks retirement of bonds 27
Amendment of section 117(d) to permit banks to take full capital losses where amounts are received on the retirement of certain corporate securities.

Deficiency letters' address--estate tax 28
Address to which deficiency letters under estate tax should be mailed in certain instances.

Returns by Bureau--statute of limitations 29
Provision that preparation of a return by the Commissioner or collector where the taxpayer fails to file his own return shall not start the running of the statute of limitations.

Philippine problems 30
Revision of the law concerning taxation of citizens in the Philippines.

Regraded Unclassified

Patent companies--personal holding company tax 31
Exclusion of bona fide patent development companies from Title IA.

Insurance companies--personal holding company tax 32
Amendment to personal holding company tax to exclude from its operation bona fide insurance companies other than life or mutual.

Collectors' suits 33
Elimination of refund suits against collectors of internal revenue.

Holding periods (section 117(h)) 34
Revision of the provisions of section 117(h) (requiring tacking of holding periods for computation of capital gain and losses in cases where substituted basis applies) to prevent such tacking in certain cases where the basis of the property sold is not really that which was applicable to the property exchanged or transferred.

Refunds in B.T.A. proceedings 35
Authority of Commissioner to make refunds during pendency of proceedings before the Board of Tax Appeals.

Cross-petitions for review of B.T.A. 36
Provision for cross-petition for review of decisions of Board of Tax Appeals, giving each party a limited period within which to file a petition for review of such decisions in case a similar petition is filed by the other party.

State courts' custody--statute of limitations 37
Extension of the statute of limitations where taxpayer's property is in the custody of State courts so that collection of Federal tax is impossible, as in the case of estates or receiverships.

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B.T.A. rules of evidence 38
Clarification of the provisions concerning the Board of Tax Appeals to specify more clearly that the rules of evidence now current in the District Court for the District of Columbia shall be the rules of evidence controlling in the Board of Tax Appeals.

Statutory refunds--statute of limitations 39
Imposition of a statute of limitations on refund claims where refunds are authorized but do not result from erroneous and illegal assessment and collection.

Earnings and profits adjustments (section 115(h))..... 40
Clarification of section 115(h) to make provision for proper adjustments of earnings and profits account in the case of certain tax-free exchanges and liquidations.

Collection in jeopardy 41
Elimination of the ten-day waiting period for distraint where collection of taxes is jeopardized.

Estate tax--gift tax credit 42
Credit under estate tax for gift tax paid on property previously transferred by gift but required to be included in gross estate under estate tax.

Gifts in trust 43
Limited extension of the $4,000 exclusion in the gift tax law to gifts in trust.

Electrical energy tax 44
Reduction of rate of electrical energy tax from 3 percent to 2 percent and an extension of its application to energy used for industrial purposes.

Cabaret tax 45
Legislation changing the structure of the rates of the cabaret tax.

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Club dues tax 46
Revision of the tax upon club dues to impose a tax upon fees for certain services which are now being billed by clubs as fees rather than dues to avoid dues.

Trailer tax 47
Imposition of tax upon commercial trailers and semi-trailers which are used in direct competition with trucks, upon which there is now a 2 percent tax.

Miscellaneous tax waivers 48
Waiver of the statute of limitations by taxpayers with respect to miscellaneous taxes.

Five percent miscellaneous tax penalty 49
Elimination of 5 percent penalty for failure to pay miscellaneous taxes.

Unjust enrichment tax 50
Transfer of certain issues under unjust enrichment tax from Board of Tax Appeals and District Courts to Board of Review.

Foreign aircraft exemption 51
Exemption from income tax of earnings derived from operation of aircraft of foreign countries which grant a similar exemption to domestic aircraft.

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1

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Elimination of dividends received from taxable income of corporations.

Until 1936 the entire amount of dividends received by corporations was deducted from gross income on the theory that taxation of intercorporate dividends would result in multiple taxation of one item of earnings. Under the present law, however, only 85 percent of such intercorporate dividends may be received tax free. The inclusion of 15 percent of intercorporate dividends in adjusted net income under the 1936 and 1938 Acts resulted from a desire to discourage the use of multiple holding companies. The problem of multiple holding companies has to a large extent been met by the Securities and Exchange Act and the Public Utility Holding Company Act of 1935. The continuation of the policy of the 1936 and 1938 Acts does result in multiple taxation. It would therefore seem desirable to return to the plan of the 1934 and prior acts and provide that the amount received by a corporation as dividends from a domestic corporation which is subject to Federal income taxation shall be deducted from gross income.

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2

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Repeal of undistributed profits tax

The present income tax on corporations retains a 2-1/2 percent tax on the undistributed profits of the corporation. It is proposed that this tax be eliminated. This removal of the undistributed profits tax would greatly simplify the provisions regarding corporate taxes inasmuch as it would make unnecessary for the general corporation tax, the present complicated provisions dealing with the dividends paid credit, the consent dividends credit, etc., which appear in sections 26, 27 and 28.

It is proposed that corporations in the future be taxed at X rate with respect to corporations having a net income of under $25,000 and at Y rate with respect to corporations having a net income over $25,000. It would, of course, be necessary that some sort of "notch" be provided to prevent an abrupt increase in the taxes of corporations having net incomes just over the $25,000 dividing line. For example, if the smaller corporations are taxed at 17 percent and the larger ones at 20 percent, the tax on a corporation with a $25,000 net income would be $4,250 but a corporation with $1 larger income, or $25,001, would pay $5,000.20 taxes. In other words an increase of $1 in income would result in an increase of $750.20 in tax. The purpose of the "notch" provision is to prevent increased income at this point from increasing tax liability by more than the amount of such increased income. However, this notch would be far simpler than the present notch provision of section 13(d).

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3

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Elimination from individual normal tax of all dividends received.

Until 1936 dividends received by individuals were subject only to surtaxes. It was thought that if a corporation pays income tax on its earnings and the stockholders again pay an income tax when such earnings are distributed to them in the form of dividends, dividend income would be discriminated against in favor of other types of income, such as interest, etc. However, the 1936 Act subjected dividends to both normal tax and surtax as part of the undistributed profits tax plan. It now seems desirable to return to the plan of the 1934 Act which allowed individuals a credit against normal tax net income of the amount received as dividends from a domestic corporation subject to Federal income taxation.

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4

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Net loss carry-over for individuals and corporations.

For a number of years, up until 1934, taxpayers were allowed as a deduction the amount of net loss (excess of deductions over gross income) which they may have had for the preceding year in their trade or business. In the Revenue Act of 1928 such losses were allowed to be carried forward for two years. In the Revenue Act of 1932 it was cut down to a carry-over for just one year. In the 1934 Act this provision was eliminated completely and has not been in effect since, except that in the 1938 Act a one-year net loss carry-over was allowed to corporations, but only as a credit for purposes of the 2-1/2 percent undistributed profits tax.

A provision of this type allowing a net loss carry-over for one or more succeeding years seems entirely fair and equitable. Its great advantage is that it tends to put businesses with fluctuating incomes upon a basis more nearly equal to that of businesses with more stable incomes.

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5

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Elimination of limitation on allowances of corporate capital losses so that such losses may be taken in full.

Section 117 (d)(1) of the Revenue Act of 1938, provides that capital losses of corporations are allowed against capital gains and against ordinary income only up to $2,000. This limitation was first placed in the law in 1934, at which time it applied both to individuals and corporations and was continued as a revenue-raising measure. Prior to that time corporate capital losses were allowed in full. When the new broader treatment was allowed individuals in the 1938 Act, however, no change was made with respect to corporations. The allowance of these losses to corporations seems equitable and proper and it is therefore proposed to remove the limitation with respect to corporations.

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6

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Repeal of the capital stock and excess-profits taxes

It is proposed that the present capital stock and excess-profits taxes with respect to corporations be repealed. This suggestion complements the proposal that the undistributed profits tax be eliminated and the entire tax on corporations be confined to a single tax, with X rate for corporations having net incomes of less than $25,000 and Y rate for corporations having net incomes of more than $25,000. Such repeal of the capital stock tax would not affect the tax for the year ending June 30, 1939 but would apply only with respect to years commencing thereafter. Similarly, as the excess-profits tax is linked to the capital stock tax, the repeal would not extend to the excess profits tax for the first income tax year ending after June 30, 1939.

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7

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Consolidated Returns.

All affiliated corporations were permitted to file consolidated returns previous to 1934, but this permission was withdrawn by the Revenue Act of 1934. The Treasury Department objected to the abolition of consolidated returns but its opposition was unsuccessful. As a consequence, consolidated returns are now permitted only in the case of railroad corporations. The suggestion that the privilege to file consolidated returns be again extended to all affiliated corporations would not entail many drafting difficulties inasmuch as it would suffice in general to merely remove the present limitation confining such privilege to railroad corporations. This change would in effect restore the situation which existed previous to 1934. It should be pointed out that in the Revenue Act of 1932 (which was the last Act in which consolidated returns were permitted for all corporations) a rate 3/4 of one percent higher than the normal corporate rate was imposed for the privilege of filing consolidated returns.

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8

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Assumption of Indebtedness

A considerable number of transfers of property, especially in connection with corporate reorganizations, are tax free, so that any gain on the transfer is not taxable at that time. A typical case is that of a corporation which transfers all its assets to another corporation in exchange for the stock of the latter. In most transfers of this nature the corporation acquiring the assets also assumes any indebtedness of the corporation transferring the assets. It had been thought by the Bureau and taxpayers alike that such assumption of indebtedness did not result in taxable gain to the transferring corporation. However, the Supreme Court in United States v. Hendler, decided last year, held that such assumption of indebtedness was in reality equivalent to the receipt of cash inasmuch as instead of the money passing from one corporation to the other and then to the creditor it passes directly from the corporation assuming the debt to the creditor. As any direct transfer of cash in such an exchange would have been clearly taxable under the law, the assumption of indebtedness was likewise held to result in taxable gain. While the correct result was reached on the facts of this particular case, the implications of the decision have caused considerable confusion. It is now difficult to forecast exactly what will result in these cases in which one corporation assumes the debts of another. The resulting uncertainty is disturbing both to the Bureau and to taxpayers. In order to remove this uncertainty and make it possible for corporations contemplating reorganization to be

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sure in advance of the tax consequences of the reorganization, it is desirable that the relevant provisions of the Revenue Act be clarified. Such clarification should proceed on the basis that the bona fide assumption of indebtedness should not result in taxable gain and adequate provisions should be inserted to prevent tax avoidance in these cases.

Regraded Unclassified

9

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Revision of the law with respect to cancellation of indebtedness.

Court decisions have held that where a perfectly solvent company buys its own bonds at a slight discount (at 95 for example), the difference between the purchase price and the face amount of the bonds is taxable income. It seems proper to impose tax in cases of this kind and other cases where solvent taxpayers discharge a debt for less than the face amount, thus freeing their assets for other purposes.

There is a large class of cases, however, where the debtor is financially embarrassed or insolvent, where it not only imposes a great hardship to impose tax upon the amount of debts cancelled but where, sometimes, there is considerable doubt as to whether any income really exists. The law in these situations is far from clear, but the following rules are now being applied:

(1) The Board of Tax Appeals holds that where the taxpayer is insolvent both before and after his debt is cancelled, there is no taxable income. But the Board holds that to the extent the taxpayer is brought "into the black" by the cancellation, taxable income is realized. The latter part of this rule seems unnecessarily harsh.

(2) At Mr. Oliphant's suggestion, the Commissioner issued a confidential mimeograph which is considerably broader than the rule of the Board of Tax Appeals. It provides that no

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taxable income is realized in any case where indebtedness is cancelled as a part of a bona fide plan to restore a financially embarrassed or insolvent taxpayer to a reasonably sound financial condition. This rule has been satisfactorily applied by the Bureau, but there is not much legal authority for it and taxpayers have never been informed that they are entitled to it. In addition it does not apply in cases like that of the Baltimore Transit Company where the company simply buys its own bonds on the market at 15 or 20.

(3) In the Chandler Bankruptcy Act a new rule was written with respect to the various bankruptcy procedures there established (77B, creditor compositions, real property arrangements, etc.) providing that in no case of a cancellation of indebtedness in one of these proceedings should any taxable income be realized. At the instance of the Treasury, however, accompanying these provisions, were enacted provisions that in any case of cancellation of a debt in one of these proceedings, the basis of all of the debtor's assets should be reduced by the amount of the debts cancelled. This basis provision was intended as a rough and ready compensation to the Treasury for the loss of revenue from non-taxation of the cancellations of indebtedness; it would increase the profit on future sales of the debtor's property which might be made, and lowers depreciation deductions. It will probably prove difficult to administer, however, and goes

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further than is justifiable perhaps, since in many instances under the Board rule or the Mimeograph, no income would have resulted from the cancellation of indebtedness even if the Bankruptcy Act had not said so. In any event, there is a real discrimination between taxpayers in bankruptcy and those who are not, since those having debts cancelled in bankruptcy get their basis reduced while those who have debts cancelled not in bankruptcy do not have their basis reduced.

Amendments to the Bankruptcy Act will probably be urged to lessen the effect of the reduction of basis provision. In addition there will be agitation for legislation which will permit financially embarrassed corporations (like the Baltimore Transit Company) to buy in their own bonds at a discount without paying tax. Some method must, therefore, be devised for eliminating confusion in these various rules and for granting such relief to financially embarrassed corporate and individual taxpayers as seems proper.

Regraded Unclassified

10

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Basis of stock dividends

The case of Eisner v. Macomber, decided in 1920 held that a distribution to common stockholders of common stock of the distributing corporation did not constitute income under the Constitution. The Court's reasoning was based on the theory that the stockholders had nothing after the distribution that they did not have before and that they merely had two pieces of paper representing the same thing that one piece of paper represented before. Until 1936 it was assumed by both Treasury and taxpayers alike that any distribution consisting of stock of the distributing corporation was not taxable as income, and that the stockholders realized no gain until they sold their shares. The regulations, therefore, provided that the basis of the old stock in the shareholders hands was to be allocated between the old stock and the new in proportion to their respective fair market value at the time of the distribution. For example, if in 1922 an individual purchased 100 shares for $1,000 and in 1924 he received a distribution consisting of 100 shares of the same corporation, the new shares having a fair market value of $750 and the old shares having a fair market value of $750 after the distribution, the basis of the old shares became $5 per share and the basis of the new shares became $5 per share, making a total basis of $1,000.

In 1936 the Supreme Court decided the case of Koshland v. Helvering (298 U. S. 441). This case involved the distribution of common stock to preferred stockholders. The Court decided

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that such a distribution was taxable upon receipt under the Constitution since the preferred stockholders received additional rights and property interests upon the receipt by them of common stock. It therefore held that the common stock should have been taxed as a dividend at the time of its receipt. Consequently the basis to be used upon a later sale of the old preferred stock should be the entire original cost of such stock, since no part of such cost needed to be allocated to the new common stock. In 1937 the Court decided the case of Helvering v. Gowran (302 U. S. 238) involving a comparable situation and held that upon a subsequent sale of the dividend stock the basis of such stock should be zero since it had cost the taxpayer nothing.

Considerable confusion and the possibility of great inequity has resulted from these two cases. Suppose that in the example given above, the taxpayer had sold his old stock before the Koshland case and pursuant to the regulations had computed gain upon a $500 basis. In 1938 he sold his new stock. Under the Gowran case he must report gain upon a zero basis. The result is that he will have recovered tax-free only $500 of his $1,000 cost. Conversely, suppose that prior to the Gowran case the taxpayer had sold his new stock and pursuant to the regulations had computed gain or loss upon a $500 basis. In 1938 he sold his old stock. Under the Koshland case he is entitled to use a $1,000 basis and thus $500 of income will have escaped taxation entirely.

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It therefore seems imperative that legislation be enacted retroactively validating the regulations in force prior to 1936 so that the gain on account of distributions of stock dividends will be computed on an allocated basis. This type of retroactive legislation is demanded by both the Bureau and taxpayers alike and will work no injustice since both parties had consistently relied upon the Treasury interpretation.

The problem does not arise in the same form with respect to stock dividends declared from 1936 on. The 1936 and 1938 Acts provided that there was to be taxed to the shareholders as a dividend all distributions which might be so taxed under the Constitution. Thus, when the taxpayer receives a different class of stock from that which he already owns, he will pay a tax upon receipt of the distribution, the basis of the old stock will be its cost, and the basis of the new stock will be its value at the time of distribution. However, distributions of common stock to common stockholders are still immune from taxation as dividends under the Sixteenth Amendment. There are certain intimations in the Koshland case that the rule of allocation applicable to such distributions may not be valid without express statutory authority. It, therefore, seems wise to provide such authority in the next revenue legislation.

Regraded Unclassified

11

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Stock rights

It has generally been assumed that the same provisions of law and the same constitutional inhibitions which apply to stock dividends also apply to distributions of stock rights. While there have been no decisions comparable to the Koshland and Gowran cases directly involving distributions of stock rights, it seems probable that these cases may govern the problem and that the same confusion will be produced with respect to stock rights as already exists with respect to stock dividends. The legislation which is recommended to cure the stock dividend situation should, therefore, probably also apply to stock rights.

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Revision of section 22(d), which provides for the use of the last-in, first-out method of valuing inventories.

The traditional method for determining the amount of inventories on hand for income tax purposes in the case of substantially all taxpayers has been the first-in, first-out method. Under that method goods sold are deemed to be from the earliest goods purchased. Accordingly, goods on hand at the time inventory is taken are deemed to be those most recently purchased. The effect of this method of accounting is that in computing costs in connection with the goods sold, the purchase prices of such goods are often based on purchases made at a considerable time before the sales are made; in the case of businesses where the sale prices are fixed more in relation to current market prices of the raw materials than in relation to original purchase prices, this results in distortion of operating income because, for income tax purposes, the operating income is computed on a basis different from that upon which the price policy of the company is based. This produces the following results: (1) In periods of rising prices, net income is unduly exaggerated, (2) in periods of declining prices, excessive losses are allowed and net income is unduly decreased.

Difficulties of the kind mentioned occur principally in businesses where raw material prices are subject to considerable fluctuation and where sales prices are fixed more on the basis of current market price of raw materials than on cost prices.

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Included among such businesses are metal refiners, manufacturers of copper and brass products, leather tanners and probably the oil business. These enterprises have sought the use of a different method of accounting for tax purposes; namely, the last-in, first-out method. Under this method, sales are deemed to be made from goods most recently purchased and the cost in computing the profit is much nearer current market prices at the time of the sale. This method thus eliminates much of the distortion in income which, as was stated, arises under first-in, first-out from the fluctuations in market price of the inventoried goods. Therefore, in periods of rising prices, net incomes of concerns using the method will be less and in periods of declining prices, their net incomes will be more.

Section 22(d) of the Revenue Act of 1938 permitted the use of this method to a limited extent in the case of specified types of business; namely, smelters and refiners of nonferrous ores and metals, producers of copper and brass products and tanners of hides or skins. Dissatisfaction exists with respect to the limitations placed on the 1938 provision. For this reason, the Treasury was requested by Senator Harrison and Chairman Doughton to carefully consider the matter. This was done with the help of outside experts and the staff of the Joint Committee. It is now proposed to lessen the restrictions and make the provision applicable more broadly without enumeration of specific lines of business.

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13

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Mortgage foreclosures

There are no express provisions in the Revenue Act dealing specifically with the question of mortgage foreclosures. As a consequence, the administrative and judicial treatment of the tax consequences of a mortgage foreclosure have changed from time to time, thereby producing inconsistent and confusing results. At the present time under the regulations when a mortgagee bids in property at a price lower than the amount of the debt he obtains a bad debt deduction for the difference between the bid price and the amount of the debt. At the same time if the actual value of the property is more than the amount of the bid he realizes a capital gain to the extent of the difference between such value and the amount of the bid. In view of the arbitrary figure at which the bid is made in many cases, a mortgage foreclosure results in a taxpayer getting a bad debt deduction and a capital gain on the same transaction. Obviously this leads to ridiculous results because by reason of the taxpayer's control of the bid price he can create bad debt deductions and capital gains almost at will. For these and other reasons the present treatment of mortgage foreclosures is unsatisfactory and should be remedied by adoption of express statutory provisions governing the tax consequences of a foreclosure.

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Revision of the provisions for taxation of mutual life insurance companies other than life.

There is now a large group of mutual companies operating in the field of fire and casualty insurance which pay practically no income tax. Stock companies doing exactly the same type of business, competing with these companies pay substantial amounts of income tax. The reasons for the present non-taxation of the mutual companies are, as follows:

(1) Section 101(11) grants an outright exemption from income tax to "farmers, or other mutual hail, cyclone, casualty, or fire insurance companies or associations." As this provision has been interpreted by the courts, most of these mutual companies receive an outright exemption from tax although some of them operate on a nation-wide, comprehensive scale.

(2) Even though they do not receive the exemption, there is a special provision in section 207 which provides these companies with special deductions for reserves for payment of losses, which are so liberal that they never report net income in excess of a very few dollars. This is true even though their financial statements show very substantial incomes, and their surplus accounts are increased by large amounts each year.

In the Finance Committee hearings in 1938, Senator Herring requested a study of this matter by the Treasury and this study has been completed, suggesting a number of ways in which the tax

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payable by these companies may be substantially increased to amounts comparable to those payable by stock companies with which they compete.

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15

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Section 820 of the Revenue Act of 1938

Prior to the adoption of Section 820 of the Revenue Act of 1938, (Section 3801, Internal Revenue Code) taxpayers were in some cases required to pay tax twice on the same item of income. For example, a taxpayer who included an item of income in his return for 1935, although such action was erroneous, may later be required by the courts to pay tax on the same item for the year 1938. If the statute of limitations had run so that the taxpayer was unable to file a claim for refund for the first tax paid, he would thus be forced to pay twice. In other instances taxpayers unfairly obtained the benefit of the same deduction twice by taking it in two years and the Commissioner was prevented by the statute of limitations from correcting the erroneous allowance of the deduction in one of the years. Section 820 remedies most situations of this nature. It is a section which operates equally as affects the taxpayer and the government and it will have the effect of eliminating a large amount of litigation and hardship.

This section should be extended, wherever possible, to other classes of cases not presently covered in which the same problem exists. In addition several clarifying amendments should be made in this section to eliminate minor questions that have arisen since its enactment.

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16

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Provision for some form of deficit cushion to allow a credit against undistributed personal holding company net income where corporation has no earnings or profits.

Under the present law a personal holding company is liable for a surtax upon such part of its statutory income as is not distributed in taxable dividends. Taxable dividends of course can only be made where the corporation has earnings or profits. Therefore if a personal holding company should by any circumstance have a statutory income but have no earnings or profits, it will have to pay the surtax even though it is impossible for it to pay any dividends to avoid the surtax. Such a situation can happen and has happened in the Foley case. In that case a personal holding company sustained a large capital loss which in its entirety reduced earnings and profits but reduced its statutory income only to the extent of $2,000. The result was that the corporation had a large statutory income which it was completely unable to distribute to avoid the undistributed profits tax because it had no earnings or profits.

It seems imperative that this situation be remedied by some type of provision which would reduce the income upon which personal holding companies surtax is imposed by the amount of any deficit in the earnings or profits account.

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17

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Amendment to the foreign tax credit provision to give proper credit for intercorporate dividends received and Federal bond interest.

Under the present law taxpayers are permitted a credit against Federal income tax for income taxes paid to foreign countries. This credit is subject, however, to certain limitations. One of these limitations is that the Federal income tax cannot be reduced more than an amount based upon the ratio between domestic income and foreign income. The smaller the domestic income the greater the foreign tax credit. Under the law prior to 1936 in determining the domestic income, intercorporate dividends and Federal bond interest were excluded. In 1936, because of certain other technical changes in the law, intercorporate dividends and such interest were included in net income. This change naturally increased the domestic income and decreased the foreign tax credit. The International Chamber of Commerce and other foreign trade groups are extremely anxious for us to return to the pre-1936 system and determine domestic income by excluding dividends and Federal bond interest. From our examination of the problem it would seem desirable to amend the provisions of section 131 to so provide.

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18

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Legislation bringing Deputy Collectors of Internal Revenue within the Civil Service and extending to them the benefits of the Retirement Act.

By an express statutory provision passed in 1913, Deputy Collectors of Internal Revenue are appointed by the Collectors without reference to the Civil Service laws. There are over 8,000 of these deputies and the administrative people of the Department feel that the administration of the revenue laws would be made more efficient if the political character of these jobs were eliminated and they were made fully subject to the Civil Service laws, and the benefits of the Retirement Act were extended to them.

It is proposed, therefore, to repeal the 1913 Act which exempts Deputy Collectors from the Civil Service laws, and provide expressly that they shall be subject to the Civil Service laws. The present personnel may continue in the service if they pass suitable non-competitive examinations. This is the procedure being applied in the case of the new employees being blanketed into the Civil Service pursuant to the Presidential Order of 1938. This change will require some revision in the relations of the collectors to the Treasury since heretofore they have been held directly responsible for all the acts of their deputies. If they are to have no power of appointment or removal of their deputies, it seems necessary to provide that such deputies shall be responsible directly to the United States as in the case of nearly all other Government employees.

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19

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Depreciation of property acquired by gift

Under the present law the basis for computing gain upon the sale of property acquired by gift is the cost of the property to the donor. The basis for computing loss, however, is the cost of the property to the donor or the fair market value of the property at the time of the gift whichever is lower.

The scheme of the Revenue Act with respect to depreciation is to provide the same basis for the computation of depreciation as is provided in the computation of gain or loss. However, section 114 merely provides that the basis for depreciation shall be the same as the basis for determining gain. Thus in the case of property acquired by gift where the fair market value at the time of the gift is less than the cost of the property to the donor, the donee is permitted to recover tax-free by way of annual deductions for depreciation the amount of the donor's cost, although he is only allowed to recover a smaller amount of market value at the time of the gift in the event of a sale of the property. This situation seems unreasonable. It therefore seems desirable that in the case of property acquired by gift the basis for depreciation should be the same as the basis for the computation of loss.

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20

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Publicity of returns.

Section 148(f) of the present law provides that the Secretary shall publish a list containing the names of, and the amount paid to, every corporate officer receiving a salary in excess of $75,000. This provision first appeared in the Revenue Act of 1934 and then applied to all salaries in excess of $15,000. The present limited effect of this provision makes it worthwhile to consider whether the provision should not be eliminated entirely. It is not in any sense a revenue measure and does not strictly belong in revenue legislation.

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21

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Repeal of the 4-cents per pound tax on imported copper.

In the Revenue Act of 1932 (section 601(c)(7)), a 4-cents per pound tax was imposed upon imported copper. It has been asserted by the smaller domestic processors and fabricators of copper products that the United States is now on export basis with respect to copper, and that domestic prices for domestic copper are fixed on an artificially high price level based upon the price charged to foreign purchasers. They claim that if this tax on imported copper were removed they would be better able to protect themselves against this artificially high price level, which depends on factors other than tariff protection. Mr. Blough will report to you on this matter.

The customs authorities have stated that there is a minor administrative difficulty, due to a present defect in this taxing provision, which should be remedied unless this tax is to be repealed.

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22

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Elimination or clarification of estate tax valuation option (section 811(j)) with particular reference to interest, rents and dividends received by the estate between the date of decedent's death and the valuation date.

Section 811(j) of the present law provides that an executor may, at his option, value the estate for the purposes of Federal estate tax as of one year after the date of decedent's death rather than as of the date of decedent's death. The purpose of this provision is apparently to insure that an estate which greatly depreciates in value before tax is payable will not be entirely eaten up by the Federal tax.

However, the Miscellaneous Tax Unit has encountered considerable difficulty in the administration of section 811(j). Problems arise with respect to the valuation of distributions made by the estate before the expiration of the one year period and with respect to the valuation of items includible in the gross estate but not forming a physical part of the estate for the purposes of administration (such as gifts made in contemplation of death).

Consideration might therefore be given to the elimination of this provision if other safeguards which are in the Act for the benefit of executors are deemed sufficient. In any event it is essential that 811(j) be clarified with respect to its most vexing problem. This problem is that of the proper treatment to be accorded income earned by the estate during the one year period. Little help in its solution is afforded by the statute. It is important that such income be included in the gross estate if the estate is valued as of one year after death,

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since otherwise the estate might receive extraordinary dividends which would materially reduce the subsequent valuation of stock owned by the decedent at the time of his death.

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23

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Amendment of an Act passed in 1879 (as amended in the Revenue Act of 1938) relating to the remission of taxes due from insolvent banks to eliminate any hardship which may result from the present provision which permits collection of such taxes immediately after depositors have been paid in full.

In 1938, at the request of representatives of certain banks and of Senator Brown, a substantial amendment was made to an old Act of 1879, which provided that where banks became insolvent and were liquidated, no tax should be collected until depositors were paid in full. The major purpose of the 1938 amendment was to provide a similar exemption where, instead of liquidating the banks, the modern procedure is applied under which the banks are reorganized and continued in business. It was, therefore, provided that in such cases where assets are segregated to pay old depositors or are held subject to a lien for such depositors, no Federal tax should be collected out of such assets until depositors are paid in full. In order to protect the Treasury, however, it was provided that after full payment of the depositors, the tax which had been suspended might then be collected, since no reason appeared why this very special exemption should be allowed to operate in favor of the stockholders. Now, however, it has been asserted that the effect may be that as soon as the bank begins to get on its feet by paying off its depositors, the Treasury will knock it down by the collection of these accumulated taxes. This assertion may be exaggerated, however, and the matter requires further study in conjunction with the Office of the Comptroller of the Currency.

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24

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Definition of control with respect to tax-free reorganizations

Under existing law, one of the prerequisites to certain tax-free reorganizations is the control of one corporation by another. The test of control in these situations was, prior to the Revenue Act of 1936, the ownership of (1) at least 80 percent of the voting stock and (2) at least 80 percent of the total number of shares of all other classes of stock of another corporation. In an attempt to remove the ambiguity respecting 80 percent of the voting stock, that portion of the test was in one provision of the Revenue Act of 1936 expressed in terms of the ownership of at least 80 percent of the voting power. Through inadvertence, this change was not made in another provision prescribing the same test. In both provisions the requirement representing the non-voting stock, if taken literally, is satisfied by the acquisition of 80 percent of the total number of shares of non-voting classes of stock. However, it has been pointed out that 80 percent of the total number of shares of the non-voting stock may not correspond with 80 percent of the total value of the non-voting stock. It has been felt that a test of 80 percent of the value would more closely reflect control than 80 percent of the number of shares. To clarify the entire situation an amendment is suggested to make the test of control in all cases dependent upon the acquisition of both (1) 80 percent of the voting power, and (2) 80 percent in value of all shares. Under this test it would not be necessary to acquire 80 percent of each class of stock but rather 80 percent of all the shares both from the standpoint of voting power and of value.

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25

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TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE March 25, 1939

TO Mr. Hanes

FROM Mr. Tarleau

Re: Legislative Proposal #25

Reference is made to #25 in your list of legislative proposals, which refers to the desirability of amending the statutes to provide that the Commissioner may make final settlement of judgments rendered against the United States. I have now been advised that by a reversal of the decision of the Comptroller General on this matter the Commissioner is making final settlement in these cases and the problem no longer exists. Therefore this proposal may be eliminated from further consideration.

JWH asked that this proposal
be taken out of list -

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Authority of the Commissioner to make final settlement of judgments for overpayment of taxes

At the present time when a court decision establishes that the taxpayer has overpaid his tax, the Commissioner may make final settlement of the amount owing to the taxpayer only if the suit was brought against a Collector of Internal Revenue. If the suit was brought against the United States, which is often the case, the Commissioner may not make final settlement of the matter but must refer it to the Comptroller General for final action.

There is no sound reason for a different method of treatment in these two situations. Moreover, the reference to the Comptroller General in the second situation is inconsistent with the general policy that the Treasury has final authority to settle all tax matters. It is desirable that the appropriate statutes be amended to provide that the Commissioner may make final settlement in all of these instances.

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26

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Deduction of Embezzlement Losses

Under the present law, losses from embezzlement are usually deductible only in the year in which the embezzlement actually occurred. However, as a practical matter in many cases the embezzlement is discovered years after it actually occurred. As a consequence, the taxpayer is often unable to obtain a deduction for the loss resulting from the embezzlement because the statute of limitations may have run with respect to refund claims for the year in which the embezzlement actually occurred. In order to permit deduction of losses from embezzlement, it is therefore desirable to amend the statute to provide generally that such losses are deductible in the year of their discovery.

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27

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Amendment of Section 117(d) to permit banks to take full capital losses where amounts are received on the retirement of certain corporate securities.

If the proposal to grant all corporations their capital losses in full is adopted, this proposal is unnecessary. Now, however, banks have a special provision in Section 117(d) allowing them their full capital losses (which are not allowed other corporations) in the case of the sale of certain corporate obligations. They assert that similar treatment is needed where, instead of selling these obligations, they are retired by the debtor corporation. No reason appears why the same treatment should not be allowed whether these obligations are sold, retired, or exchanged, and it is therefore proposed to amend the statute to accomplish this result.

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28

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Address to which deficiency letters under estate tax should be mailed in certain instances.

Under the present law a deficiency letter may be mailed to the last known address of the taxpayer if the deficiency letter concerns the income tax or the gift tax. There is no corresponding provision in the estate tax law to permit mailing of the deficiency letter to the last known address of the executor, who is the person responsible for payment of the estate tax. For administrative reasons it is desirable that the estate tax law be amended to permit mailing of a deficiency letter to such address. Such amendment would also be accompanied by a provision that if notice is received from a person to the effect that he is no longer acting as executor, it would be proper for the Bureau to send a notice of deficiency to the last known address of the decedent.

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29

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Effect of return prepared by Collector or Commissioner where taxpayer has failed to file a return

Where the taxpayer fails to file a return there is no limitation on the time in which the Commissioner may attempt to assess and collect a tax for that year. Where the taxpayer does file a return, there is a three-year limitation. In a case where a taxpayer fails to file his return, the Collector or the Commissioner is authorized to file a return for such taxpayer. This action on the part of the Commissioner or Collector is necessary to start the regular procedure of assessment and collection. Some courts have stated that if a taxpayer fails to file a return, but the Commissioner or Collector files one for him, such return makes applicable the three-year statute of limitations. Inasmuch as the return filed by the Commissioner or Collector is necessarily incomplete because of his lack of knowledge of the actual facts and is a purely procedural matter, it is understandable that such return should have this effect. Consequently, the appropriate statute may have to be amended to provide that in these situations the filing of a return by the Commissioner or Collector shall not result in making applicable the three-year statute of limitations.

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30

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Revision of the law concerning taxation of citizens in the Philippines.

There are a number of proposals which have been suggested intended to improve the status of citizens of the United States residing in the Philippines. In general it can be said that these persons are now treated in a manner somewhat similar to the treatment of citizens of the United States residing and deriving income in foreign countries. The argument in behalf of the citizens in the Philippines is that they should be treated more like citizens residing and earning income in the various States. This involves a fundamental question of policy regarding the relationship of the United States to the Philippines which must be given further consideration in order to solve the various problems which exist with respect to this matter.

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31

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Exclusion of bona fide patent development companies from Title IA.

The personal holding company tax is imposed at a very high rate (75 percent) upon the undistributed income of companies which come within the definition of personal holding companies. The definition depends in part on the nature of income derived by such companies and includes companies closely held which derive all their income from investment sources, such as rents, royalties, and capital gains. Attention has been directed to a very few so-called patent development companies which are firms of engineers engaged in developing new patent processes and devices and which thus perform a very useful service in our economy. The compensation of these companies is derived either from royalties or from capital gains on the sale of stock which they receive for their services. As a result, when closely owned, they are subject to the tax on personal holding companies which is an undue hardship, since they are operating concerns and not of the type intended to be caught by that tax. An amendment seems necessary to grant some form of exemption to these companies which will free them from the burden of this tax.

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32

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Amendment to personal holding company tax to exclude from its operation bona fide insurance companies other than life or mutual.

Under the present law a special tax is levied upon the undistributed income of personal holding companies in order to prevent tax avoidance through the use of such companies. One of the tests in ascertaining whether a company is a personal holding company is whether 80 percent of its gross income comes from dividends, interest, royalties, or annuities. The gross income of insurance companies, other than life or mutual, is expressly defined by the law to consist of investment income, and underwriting income, which consists of the premiums earned less losses and expenses incurred. As a consequence of this special definition of gross income, if such an insurance company has no underwriting income because its losses and expenses exceed its premiums, but has investment income, 80 percent of its gross income comes from the type of income necessary to make it a personal holding company and it is taxed as such. It was never intended that a bona fide operating insurance company should be taxed as a personal holding company in such a situation and the difficulty arises merely from the technical definition of gross income in this particular situation. It is, therefore, desirable that the appropriate statute be amended to prevent taxation of such insurance companies as personal holding companies in the situation described above.

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33

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Elimination of refund suits against Collectors of Internal Revenue

At the present time a taxpayer who claims that he has overpaid his tax may file suit against the United States or against the appropriate Collector of Internal Revenue as an individual. If the taxpayer wins such suit against the collector, provision is made for payment by the United States of the amount claimed. Likewise, provision is made for the United States District Attorney to defend the collector in such case. As a consequence, the suit against the collector, although in form a personal suit against him, is in reality a suit against the United States. The present existence of this personal suit against the Collector is an anachronism and has been criticized by the Supreme Court because of its antiquated nature. Its existence creates difficulty and confusion in tax litigation. There is no reason for the continuation of such suits inasmuch as the opportunity to sue the United States in a District Court or the Court of Claims is thoroughly adequate. Consequently the appropriate statutes should be amended to eliminate such suits against collectors. It should be noted that as a jury trial in tax matters may be obtained only in a suit against the collector, elimination of such suits would mean the elimination of jury trials in tax cases. However, there are only two or three such jury trials each year and it is recognized that the use of a jury in tax matters is outmoded and unwise.

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34

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Revision of the provisions of section 117(h) (requiring tacking of holding periods for computation of capital gain and losses in cases where substituted basis applies) to prevent such tacking in certain cases where the basis of the property sold is not really that which was applicable to the property exchanged or transferred.

Under the capital gain and loss provisions the length of time property is held has an effect upon the determination of the amount of gain or loss recognized to the seller upon the sale of property. Where property is transferred in a non-taxable transaction and the transferee takes the property over at the same cost basis as it had in the hands of the transferor, the Revenue Act provides generally that when the transferee sells the property he shall be deemed to have held it not only for the period of his own ownership, but also for the period during which the transferor owned it.

There are certain cases, however, where this provision is too broad in that it applies to situations where the basis of the property sold is not really the same as its basis was in the hands of the person whose holding period is "tacked". For example, for the purpose of computing loss on a sale of property acquired by gift, the basis is the donor's basis or fair market value at the date of the gift, whichever is lower. If fair market value is lower, the basis has no reference to the basis in the hands of the donor and there is no reason why the donor's holding period should be tacked. In the example just given, if the holding period of the donor is tacked to the holding period of the donee the result will be that the amount of loss allowed to the donee may be less than it would be if no tacking took place.

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There are other instances where holding periods are tacked and such tacking seems unjustifiable. A study is being made with a view to correcting these situations.

Regraded Unclassified

35

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Authority of Commissioner to make refunds during pendency of proceedings before the Board of Tax Appeals

At the present time if the taxpayer is claiming before the Board of Tax Appeals that he has overpaid his tax, the Commissioner may not make any refund of such taxes until the Board of Tax Appeals has rendered a final decision in the matter. It often happens that the Commissioner during the pendency of the proceedings before the Board is willing to concede that the taxpayer is correct with respect to part of his claim and would be willing, consequently, to refund to him a portion of the amount claimed. However, the Commissioner is unable to make such refund under the present provisions but must wait until the decision of the Board on the other matters becomes final. As a result the Commissioner must pay interest on the amount of such refund for this intervening period, whereas if the refund could have been made during the pendency of the proceedings, the amount of interest could have been saved. Moreover, in a case where the Commissioner contests the entire claim of the taxpayer and the Board decides in favor of a taxpayer and the Government decides not to appeal, as a decision of the Board does not become final until three months thereafter, the Commissioner cannot make the refund until the three months has expired.

In order to enable the Commissioner promptly to make refund when he concedes the claim of the taxpayer prior to decision or where the Board decides in favor of the taxpayer, and to save the Government the

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requirement of paying interest for any further time in such cases, the appropriate statutes should be amended to enable the Commissioner to make refunds during the pendency of Board of Tax Appeals proceedings.

Regraded Unclassified

36

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Cross-petitions from Board of Tax Appeals

At the present time the taxpayer and the Commissioner are each given three months within which to file a petition appealing from the decision of the Board of Tax Appeals. In many cases the Board decides some of the issues in favor of the taxpayer and some in favor of the Commissioner, so that both parties would be satisfied if neither appealed. However, if one party does not appeal and the other party does appeal, the latter naturally is in an advantageous position. He cannot be deprived of that part of the decision below which was in his favor, and he is in a position to question that part of the decision which he lost. To prevent the other party from obtaining such an advantageous position by filing his petition just before the three months period expires, both parties are forced to appeal, although each would be satisfied with the decision of the Board if the other party has not appealed. To avoid these unnecessary appeals, the appropriate statutes should be amended to provide that if one party files a petition for appeal, the other party is given 15 extra days after the expiration of the normal period in which he may file his petition. This would eliminate the necessity of filing a petition merely for protection in case the other party decides to appeal. It will thus reduce the number of appeals from the Board of Tax Appeals.

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37

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Extension of the statute of limitations where taxpayer's property is in the custody of State courts so that collection of Federal tax is impossible, as in the case of estates or receiverships.

In cases where property of taxpayers is in the custody of representatives of State courts, such as executors of estates or receivers in court proceedings, the collectors cannot distrain on the property which is so held and thus in effect are precluded from making collection of tax. The statute of limitations on collection under Federal laws, however, continues to run even though collection is thus made impossible. For example, a tax may be due from an executor of an estate and due to the pendency of probate proceedings the collector is prohibited from collecting the tax but nevertheless the three-year statute of limitations may run so that the tax cannot be collected when the probate proceedings are terminated. This same thing may happen in the case of a receivership. Therefore it is proposed that the statute of limitations be suspended, or extended, in these cases, so that if the statute of limitations requires collection within three years, for example, the three years will be added to the time in which the taxpayer's property is in the custody of a State court.

Regraded Unclassified

38

Regraded Unclassified

Rules of Evidence of the Board of Tax Appeals.

When the Board of Tax Appeals was created it was provided that the rules of evidence applicable in equity cases in the courts of the District of Columbia should be the rules of evidence applicable in proceedings before the Board of Tax Appeals. At that time different rules of evidence were applicable in law cases and in equity cases in the courts of the District of Columbia. As a result of the Rules of Procedure for the Federal Courts recently promulgated by the Supreme Court, the rules of evidence applicable in the Courts of the District of Columbia are now the same whether the case is one that was formerly termed a law case or an equity case. In view of the change thus effected, confusion may result if the reference to equity cases is retained in the provision fixing the rules of evidence for the Board of Tax Appeals. It is, therefore, desirable that the appropriate statute be amended to clarify this situation, the change being purely a technical one. Before this change is made the Board of Tax Appeals will be consulted.

Regraded Unclassified

39

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Imposition of a statute of limitations on refund claims where refunds are authorized but do not result from erroneous and illegal assessment and collection.

It sometimes happens that due to an inequitable situation Congress provides for the refund of taxes which were quite properly collected under the authority of a statute imposing them. The statute of limitations now applies only with respect to claims for refund of taxes improperly collected. Consequently there is no general limitation provision applicable to the type of cases referred to in the first sentence. Sometimes these specific refunding provisions state their own period of limitations on claims. A study is being made however to ascertain whether some refund statutes have been passed where this was not done. If it appears that there are such statutes, a general statute of limitations should be imposed with respect to such claims.

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Clarification of section 115(h) to make provision for proper adjustments of earnings and profits account in the case of certain tax-free exchanges and liquidations.

Dividends are not taxable as dividends to the shareholders of a corporation unless such dividends are out of the earnings or profits of the corporation. Consequently the earnings or profits account becomes of great importance both to the corporation and to the Treasury. To the extent that the earnings and profits account is smaller it is to the advantage of the taxpayer, since that means less taxable distributions. To the extent that it is larger the Treasury naturally benefits. Stock dividends and reorganization distributions are non-taxable and are regarded as not reducing earnings and profits, but are regarded as capital transactions, and the purpose of section 115(h) is so to provide. However under the language of existing law, section 115(h) is ambiguous and may result in the non-reduction of earnings and profits in certain cases in which the taxpayer may fairly claim that they should be reduced. Consequently the section requires clarification to accomplish this result.

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Elimination of the ten-day waiting period for distraint where collection of taxes is jeopardized

Under present law if it has been established that a tax is owing from the taxpayer he is given ten days within which to pay such tax after notice and demand from the collector. If the tax is not paid within such ten days the collector is authorized to distrain upon the property of the taxpayer. This authorization to distrain means that the collector may attach the property of the taxpayer, publish a notice that such property has been seized and will be sold at a stated time, and then offer such property for sale, the proceeds of the sale being used to pay the tax. In some cases the requirement that the collector must wait ten days before attaching the property of the delinquent taxpayer has permitted the taxpayer to avoid payment by so disposing of his property that the collector is unable to obtain it when the ten days has expired. In order to prevent such evasion of collection, the Bureau states that it is desirable to amend the law so that in cases where the Commissioner believes that collection of the tax would be jeopardized if the collector waits until the ten-day period expires, the collector is authorized to attach the property at once upon refusal of the taxpayer to pay the tax. It should be noted that this authority could only be exercised in cases where it has become clearly established that the taxpayer owes the tax in question. Moreover, after the property has been attached the collector would then have to give the requisite notice of sale and proceed as in

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the ordinary case. The sale cannot be held until after the ten-day period is up. The amendment would, therefore, simply authorize the collector to keep the property in his custody during this ten-day period, as well as thereafter, in cases in which it is believed that unless such property is so taken it will not be available for payment of taxes when the ten-day period expires.

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Credit under estate tax for gift tax paid on property previously transferred by gift but required to be included in gross estate under estate tax.

Gifts made in contemplation of death are subject to a gift tax when made and are also required to be included in the gross estate for estate tax purposes when the donor dies. However, to prevent double taxation a credit against the estate tax is allowed for the gift tax previously paid. As the gift tax is a graduated and cumulative tax, any gift made will not only bear a tax but will also affect the rate payable on any other gifts made during that year or succeeding years. Consequently, it is necessary to ascertain what amount of gift tax is traceable to the gift made in contemplation of death. The present statute solves this problem by providing that the credit be determined by taking the average rate of gift tax paid for the year in question and applying that rate to the amount of the gift in contemplation of death.

It has been suggested that the credit should be the difference between the gift tax actually paid on all gifts and the amount of gift tax that would have been paid if the gift in contemplation of death had not been made. This would have the effect of providing a credit based upon the highest rates of gift tax paid by the donor. If the suggested method is found to be without objection after examination, the appropriate statute should be amended to substitute that method for the present averaging method.

Regraded Unclassified

43

Regraded Unclassified

Limited extension of the $4,000 exclusion in the gift tax law to gifts in trust.

Prior to the Revenue Act of 1938, under the gift tax law the first $5,000 of gifts to a person during a single year were excluded. It was found that this exclusion was being abused by some taxpayers. Sometimes one trust is created with a number of beneficiaries and the grantor urges that the number of beneficiaries and not the number of trusts are to determine the number of exclusions to which he is entitled. In another case, however, the taxpayer forms a number of trusts for one beneficiary and urges that the number of the trusts and not the number of the beneficiaries is to determine the number of exclusions to which he is entitled. The courts have had great difficulty with these situations and the law on this point was in confusion with the result that more exclusions were being obtained than were proper. To eliminate these obvious possibilities of tax avoidance, the gift tax was amended to deprive gifts in trust of any exemption whatsoever. (At the same time the figure for gifts in general was reduced to $4,000.) While this amendment effectively eliminates such tax avoidance, it probably operates with undue hardship in the case of bona fide gifts in trust. It may be desirable to amend the statute to allow some exemption in the case of gifts in trust if that can be done without at the same time permitting the tax avoidance which existed prior to the amendment.

Regraded Unclassified

44

Regraded Unclassified

Reduction of rate of electrical energy tax from 3 percent to 2 percent and an extension of its application to energy used for industrial purposes.

The tax on electrical energy is imposed at the rate of 3 percent upon sales of such energy for domestic and commercial uses. Great difficulty is experienced by the Bureau in drawing the line between commercial uses, which are taxed, and industrial uses which are not taxed. For example, the question has arisen as to whether use by a laundry is a commercial use or an industrial use. The burden is primarily upon the power companies which must determine whether or not to collect this tax with respect to each of their consumers. In order to eliminate this severe burden on both the power companies and the Bureau, it is proposed that the rate of tax be lowered from 3 percent to 2 percent and that the tax be imposed with respect to all uses of electrical energy which would of course include energy used for all industrial purposes.

Regraded Unclassified

45

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Legislation changing the structure of the rates of the cabaret tax.

The tax on cabarets has proved exceedingly difficult to administer due entirely to its present structure. It must be remembered that this tax is collected from relatively small taxpayers, many of whom are relatively uneducated persons, and it is almost impossible to instruct these persons in the proper method of withholding and paying this tax. To aid in understanding the difficulty which exists with respect to it the taxing provision is quoted:

> "A tax of 1-1/2 cents for each 10 cents or fraction thereof of the amount paid for admission to any public performance for profit at any roof garden, cabaret, or other similar entertainment, to which the charge for admission is wholly or in part included in the price paid for refreshment, service, or merchandise; the amount paid for such admission to be deemed to be 20 per centum of the amount paid for refreshment, service, and merchandise. Where the amount paid for admission is 50 cents or less, no tax shall be imposed."

To eliminate these unnecessary difficulties it is proposed that the tax be changed to a gross receipts tax at the rate of 3 percent which could be easily computed and would produce about the same revenue as the present tax.

Regraded Unclassified

46

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Revision of the tax upon club dues to impose a tax upon fees for certain services which are now being billed by clubs as fees rather than dues to avoid dues.

The tradional method of financing country club operations has been through the charges for dues levied upon club members. These dues entitle members to the use of all of the athletic facilities of the clubs. In order to avoid payment of the tax on club dues, however, certain clubs hit upon the device of charging only a very small amount as dues and billing members for the balance of the necessary funds as annual fees charged, for example, for the use of golf facilities. The privileges and rights of members are the same as they were before and all members are expected to pay the golf fee, but the courts have held that such fees are not dues and therefore not taxable. If this device is allowed to continue in use the tax on dues is virtually nullified, since clubs are rapidly changing over their method of operation to avoid the tax. To eliminate the use of this device, it is proposed to include in the definition of dues, fees charged on an annual, quarterly, or monthly basis for the use of golf, tennis, and similar athletic facilities. This should terminate the major weaknesses in the tax which have developed and again permit its proper enforcement.

Regraded Unclassified

47

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Imposition of tax upon commercial trailers and semi-trailers which are used in direct competition with trucks, upon which there is now a 2 percent tax.

Since 1932 there has been a tax at the rate of 2 percent upon the sale of trucks by the manufacturer. In 1935 it appeared that there were being sold a large number of vehicles known as tractors, consisting of a motor and four or six wheels, the function of which was to support and pull a four-wheeled trailer or two-wheeled semi-trailer. These units were in direct competition with trucks, but prior to 1935 were not subject to tax. In the Revenue Act of 1935, a provision was enacted to impose a tax upon tractors of this type used for highway transportation in combination with trailers or semi-trailers. No tax was imposed at that time, however, on the trailer or semi-trailer portion of the unit. To equalize the burden upon all vehicles used for highway transportation it is now proposed to impose the tax also upon these trailers or semi-trailers.

Regraded Unclassified

48

Regraded Unclassified

Waiver of the statute of limitations by taxpayers with respect to miscellaneous taxes

Under the present income tax law, provision is made for the taxpayer to waive the statute of limitations and thus prevent such statute from running with respect to the assessment and collection of the tax. If such waivers could not be made the Commissioner would be forced to assess the tax which he thought due even though he had not had ample time to ascertain the correct amount, since to delay assessment would permit the statute of limitations to run and thus prevent any assessment whatsoever. The provision for waiver of the statute of limitations thus makes it possible for the taxpayer and the Commissioner to reach an agreement on the correct amount of tax due by providing ample time within which all the aspects of the case may be considered. There is no similar provision permitting waiver of the statute of limitations as regards the miscellaneous taxes. It has therefore been suggested that the appropriate statutes be amended to permit the taxpayer to waive the statute of limitations whenever he so desires. It must be noted that such waiver on the part of the taxpayer is purely voluntary and entirely within his control.

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Elimination of 5 percent penalty for failure to pay miscellaneous taxes.

At one time the revenue acts levied a 5 percent penalty for failure to pay the amount of tax due within ten days after notice and demand. This penalty has been removed with respect to income, estate and gift taxes, inasmuch as the present 6 percent interest on delinquent payments is entirely adequate to insure prompt payment in most cases. However, the 5 percent penalty still exists with respect to miscellaneous taxes, so that a taxpayer who fails to pay a miscellaneous tax owing by him is subject to both a penalty of 5 percent of the amount of tax owing and to 6 percent interest on such amount from the date it should have been paid. It has been suggested by the Bureau that the 5 percent penalty in the case of miscellaneous taxes should be eliminated in accordance with the previous action with respect to income, estate and gift taxes, inasmuch as the reason for such penalty no longer exists in view of the interest that must be paid by delinquent taxpayers. This matter is being studied but before a final decision is reached it is necessary to ascertain whether there is objection from the Alcohol Tax Unit which once voiced opposition to this proposal.

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50

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Transfer of certain issues under unjust enrichment tax from Board of Tax Appeals and District Courts to Board of Review.

After the processing taxes in the Agricultural Adjustment Act were held unconstitutional the problem arose as to what to do with processors who had not paid the tax which was imposed on the first domestic processors but had included the amount of such tax in the purchase price charged and collected from their customers. To meet these problems, the "unjust enrichment" tax was enacted which imposed an income tax on income derived from the sales of articles with respect to which a processing tax was owing which the taxpayer had not paid, to the extent that the burden of the tax had been previously shifted by him to others. The Board of Tax Appeals has jurisdiction over deficiencies arising under this unjust enrichment tax. At the same time, provisions were adopted whereby any taxpayer who had actually paid a processing tax could obtain a refund only if he could prove that he had not shifted the burden of the tax to others. The Board of Review in the Treasury Department has jurisdiction over questions relating to refunds of such processing taxes. This special Board of Review was created because it was thought that the legal and economic problems involved in ascertaining whether the tax burden of the processing tax had been shifted to other persons were so complicated as to require handling by a specialized tribunal. As these same complex legal

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and economic issues are involved under the unjust enrichment tax, it is suggested that the jurisdiction of the Board of Tax Appeals under the unjust enrichment tax with respect to these questions be transferred to the Board of Review. If this were done, all of the difficult questions concerning processing taxes would be decided by one tribunal.

Where a taxpayer pays an unjust enrichment tax and later sues for a refund the District Courts of the United States and the Court of Claims have jurisdiction over such suits for refund. If the above suggestion that all questions involving the issues arising with respect to the processing taxes be shifted to the Board of Review is approved, it would therefore be necessary to provide that such refund suits should also be heard by the Board of Review.

This matter will be taken up with the Board of Tax Appeals and the Board of Review.

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Exemption from income tax of earnings derived from operation of aircraft of foreign countries which grant a similar exemption to domestic aircraft.

Section 212(b) and 231(d) of the Internal Revenue Code now grant an exemption from income tax in the case of earnings derived from the operation of ships documented under the laws of foreign countries if such foreign countries grant similar privileges to ships registered under the laws of the United States. These provisions have been thought to be desirable to encourage international trade, though since more shipping is done with the United States by foreign vessels than by domestic vessels, the exemption has operated to the disadvantage of the United States. It now appears that international operation of aircraft on a substantial scale will be commenced in the near future and it therefore seems desirable to grant an exemption similar to that now provided for ships to apply in the case of aircraft. Such a provision is now provided for by a treaty with France, and a number of other countries have expressed a desire for similar reciprocal exemptions. Since the operations of American aircraft will probably exceed those of foreign aircraft, the extension of this exemption to aircraft should result in a net advantage to the United States.

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