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Tax Legislation Enacted by the 78th Congress - Analysis of Principal Changes

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SECTION ON TAXATION

EDITOR'S NOTE: The opportunity for intensive study of various phases of taxation provided by the broad scope of tax course offerings has been productive of many tax articles of real interest. Those selected for publication are included in this section of the Review.

The course offerings in taxation at the Marshall-Wythe School of Law include Survey of Tax Literature, Basic Federal Taxation, State and Local Taxation, Tax Administration and Procedure, Adjective Tax Law, Preparation of Tax Forms, Estate and Gift Taxation, Advanced Income Taxation, and Tax Research. Most of these course offerings are open to second and third-year law students on an elective basis. All are required for the Degree of Master of Law and Taxation.

The Master of Law and Taxation Degree was instituted at the Marshall-Wythe School of Law for the purpose of providing an opportunity for added scope and depth in the study of, and inquiry into, tax policy, theory and practice. Prerequisites for this degree, in addition to academic baccalaureate and law degrees and the courses in Taxation listed above, include the following undergraduate courses in the fields of Business Administration and Economics: Advanced Accounting, Cost Accounting, Auditing, Municipal and Governmental Accounting, Money and Banking, Statistics, Corporate Finance, Investments, Public Finance and National Financial Policy, and Government Regulation of Business.

A contributing factor to the interest in the study of taxation has been the papers presented at a Conference on the History and Philosophy of Taxation held at the College of William and Mary in 1955. These papers include "History of Taxation in the United States" by Randolph Paul; "Basic Tax Issues" by Roy Blough; "The Tax Court of the United States, Its Origin and Functions" by Bolon B. Turner; "Enforcement" by E. Barrett Prettyman; "Influence of the Courts on Tax Policy" by Joel Barlow; "Accounting Theory and Taxation" by Mark E. Richardson; and "The Role of Taxation in a Free Enterprise System" by C. Lowell Harriss.

The study of taxation has been given further encouragement by papers presented each year at the Annual Tidewater Tax Conference sponsored by the Marshall-Wythe School of Law. Some of these papers have been published in earlier volumes of this Review.

The subject matter covered by tax articles contributed by students and others interested in the field of taxation and published in the Law Review for the years 1957 through 1962 is indicated by the following titles:

The Tax Practice Controversy in Historical Perspective. Joseph V. Anderson, 1957, vol. 1, no. 1, p. 18.

Virginia Income Taxation of Individuals—Some Comparisons with the Federal Law. E. McGruder Faris, 1957, vol. 1, no. 1, p. 38.

Some Differences Between Federal and Virginia Taxation in the Estate and Gift Tax Fields. H. Brice Graves, 1957, vol. 1, no. 1, p. 69.

Taxes Imposed by the Federal Government—Their Nature, Rates, and Methods of Reporting and Payment. Thomas J. Middleton, Jr., 1958, vol. 1, no. 2, p. 374.

Compensation from an Employment (Internal Revenue Code of 1954, sec. 1301). R. Harvey Chappell, Jr., 1959, vol. 2, no. 1, p. 3.

Taxes Imposed by the Virginia Code–Their Nature, Rates and Methods of Reporting and Payment. Frederick P. Aucamp *et al.*, 1959, vol. 2, no. 1, p. 104.

Tax Effects of Divorce, Marital Separation and Support Agreement. Lester I. Bowman, 1960, vol. 2, no. 2, p. 297.

Short Term Trusts. J. W. Hornsby, 1960, vol. 2, no. 2, p. 311.

Observations on the Tax Immunity of Federal Properties and Operations in Virginia. John M. Court, 1960, vol. 2, no. 2, p. 460.

Taxation, Amount Received for Future Damages. John J. Harrington, 1960, vol. 2, no. 2, p. 514.

The Civil Aspects of the Net Worth Method. Richard D. Schwab, 1961, vol. 3, no. 1, p. 65.

A Roadmap of Subchapter S. Robert S. Bersch, 1961, vol. 3, no. 1, p. 99.

The Deductibility of Moving Expenses and Investigatory Expenses. Bernard Goldstein, 1961, vol. 3, no. 1, p. 115.

The Real Estate Investment Trust: A New Medium for Investors. A. Overton Durrett, 1961, vol. 3, no. 1, p. 140.

Federal Income Taxation: Meals and Lodgings Furnished for the Convenience of the Employer—Two Sequels to the Boykin Case. Rexford R. Cherryman, 1961, vol. 3, no. 1, p. 166.

Some Problems Facing the Tax Court. Norman O. Tietjens, 1962, vol. 3, no. 2, p. 453.

Collapsible Corporations: A Question of Intent. Douglas W. Conner, 1962, vol. 3, no. 2, p. 483.

Tax Planning for the Hobby Enthusiast. Daniel U. Livermore, 1962, vol. 3, no. 2, p. 498.

§304 of the Internal Revenue Code of 1954: Redemptions by Related Corporations. Thomas D. Terry, 1962, vol. 3, no. 2, p. 457.

Deductibility of Living Expenses as Medical Expenses. Edmund L. Walton, Jr., 1962, vol. 3, no. 2, p. 511.

TAX LEGISLATION ENACTED BY THE 87TH CONGRESS—ANALYSIS OF PRINCIPAL CHANGES

SAMUEL R. MCCLURD*

EDITOR'S NOTE: *Mr. Samuel R. McClurd, Director, Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, was invited to informally summarize the principal changes in the Internal Revenue Code effected by legislation of the 87th Congress for the information of the conferees attending the Eighth Annual Tide-*

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water Tax Conference held on the Campus of the College of William and Mary at Williamsburg, Virginia, on December 8, 1962. Mr. McClurd emphasized that the summary represents his personal views and is not to be interpreted in any sense as the official opinion of the Department of the Treasury or any unit thereof. The summary presented by Mr. McClurd is reproduced herein.

I.

The 87th Congress convened on January 3, 1961, and adjourned on October 13, 1962. The tax legislation enacted by the 87th Congress surpasses in scope and significance that enacted by any other Congress in recent years. In addition to passing the Self-Employed Individuals Tax Retirement Act of 1962[1] and Revenue Act of 1962,[2] the 87th Congress enacted over 40 other public laws affecting internal revenue. Some of these laws deal exclusively with internal revenue matters; while others deal primarily with non-revenue matters, but contain incidental provisions relating to internal revenue; such as, the Federal-Aid Highway Act of 1961,[3] relating to the rates of certain miscellaneous excise taxes connected with highway use; the Mutual Educational and Cultural Exchange Act of 1961,[4] relating to the tax treatment of payments to foreign students and exchange visitors; the Peace Corps Act,[5] relating to the tax treatment of payments to Peace Corps volunteers and volunteer leaders; and the Trade Expansion Act of 1962,[6] which provides for a 5-year net operating loss carryback in cases where the loss is due to reduction in tariff barriers. A substantial number of the laws enacted by the 87th Congress relate primarily to tax rates, for example, the Tax Rate Extension Acts of 1961[7] and 1962.[8] Other laws enacted by the 87th Congress relate to social security,[9] Federal unemployment,[10] and miscellaneous

[1] 76 Stat. 809 (1962).

[2] 76 Stat. 960 (1962).

[3] 75 Stat. 122, 123 (1961).

[4] 75 Stat. 527, 535 (1961).

[5] 75 Stat. 612, 625 (1961).

[6] 76 Stat. 872, 889 (1962).

[7] 75 Stat. 193 (1961).

[8] 76 Stat. 114 (1962).

[9] Social Security Amendments of 1961, 75 Stat. 131, 140.

[10] Temporary Extended Unemployment Compensation Act of 1961, 75 Stat. 8, 16.

excise taxes.[11] Other laws exempt from income tax funds distributed to members of certain Indian tribes.[12]

In view of the breadth of the subject, it is obvious that none of the more important enactments can be discussed in detail. In presenting the subject, I will first merely mention some significant tax enactments of the 87th Congress; and I will then discuss in some detail some of the more important provisions of the Self-Employed Individuals Tax Retirement Act of 1962[13] and of the Revenue Act of 1962.[14] The discussion must necessarily be quite general and in some instances special qualifications and restrictions must necessarily be omitted.

Some of the significant enactments are: Public Law 87-109,[15] which permits prepaid dues of certain membership organizations, such as nonstock, nonprofit automobile clubs on the accrual method, to be spread over the period during which there is liability on the part of the organizations to provide services, instead of being reported in the earlier year in which the income is received; Public Law 87-312,[16] which provides for an election regarding depletion allowances for open taxable years beginning before 1961 in the case of certain clays and shale used in the manufacture of burnt clay products; Public Law 87-321,[17] which provides for a credit against the Federal unemployment tax for certain successor employers and for an election regarding depletion allowances for open taxable years beginning before 1961 in the case of quartzite and clay used in the production of refractory products; Public Law 87-370,[18] which relates to annuities for widows and dependent children of Tax Court judges and extends to employees of public schools the same preferred annuity treatment accorded employees of section 501 (c)(3) organizations under Code

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[11] 75 Stat. 40 (1961); 76 Stat. 156, 166 (1962); 76 Stat. 1134 (1962); 76 Stat. 1138 (1962); see also notes 3, 7, and 8, *supra*.

[12] *e. g.*, 75 Stat. 474 (1961); 75 Stat. 639 (1961); 76 Stat. 698, 703 (1962); 76 Stat. 704, 709 (1962); 76 Stat. 775 (1962).

[13] *Supra*, note 1.

[14] *Supra*, note 2.

[15] 75 Stat. 222 (1961).

[16] 75 Stat. 674 (1961).

[17] 75 Stat. 683 (1961).

[18] 75 Stat. 796, 801 (1961).

section 403 (b); Public Law 87-397,[19] which authorizes the Secretary of the Treasury by regulations to require the use of identifying numbers on tax and information returns and other documents— this law constitutes the keystone of the automatic data processing system now being instituted by the Internal Revenue Service; Public Law 87-403,[20] which relates to the income tax treatment of distributions of General Motors stock pursuant to the du Pont antitrust order; Public Law 87-426,[21] which permits a taxpayer to elect to deduct certain disaster casualty losses in the taxable year prior to the taxable year in which the losses occurred; Public Law 87-520,[22] which extends the Renegotiation Act of 1951[23] until June 30, 1964, and provides for judicial review of Tax Court decisions in renegotiation cases; Public Law 87-682,[24] which accords to fishermen the same estimated income tax treatment as is available to farmers; Public Law 87-710,[25] which provides a 7-year net operating loss carryover for regulated transportation corporations; Public Law 87-768,[26] which excepts certain consumer finance companies from the personal holding company tax; Public Law 87-790[27] and Public Law 87-858,[28] which make limited changes in the income tax treatment of life insurance companies; Public Law 87-858[29] also amends the special rule for determining constructive sales price for manufacturers excise taxes and provides an extra 10 percent charitable contribution deduction for gifts to foundations for certain State colleges and universities; Public Law 87-863,[30] which increases the maximum limitations on the medical expense deduction, permits qualified pension plans to provide medical and health benefits if they are subordinate to retirement benefits, provides

[19] 75 Stat. 828 (1961).
[20] 76 Stat. 4 (1962).
[21] 76 Stat. 51 (1962).
[22] 76 Stat. 134 (1962).
[23] 73 Stat. 210 (1959).
[24] 76 Stat. 575 (1962).
[25] 76 Stat. 648 (1962).
[26] 76 Stat. 766 (1962).
[27] 76 Stat. 808 (1962).
[28] 76 Stat. 1134 (1962).
[29] *Ibid.*
[30] 76 Stat. 1141 (1962).

under certain conditions a new option to expense intangible drilling and development costs, and provides for the treatment of net operating losses and capital losses in cases arising out of the restoration of amounts held under claim of right; Public Law 87-870,[31] which relates to the income tax treatment of terminal railroad corporations and their shareholders and the treatment of certain cooperative banks as domestic building and loan associations; and Public Law 87-876,[32] which provides for an increase in the retirement income credit in certain cases and amends those provisions of the Revenue Act of 1962[33] relating to the taxation of mutual savings institutions to eliminate an unintended possible benefit.

II.

Self-Employed Individuals Tax Retirement Act of 1962

One of the most important bills enacted by the last congress is the Self-Employed Individuals Tax Retirement Act of 1962,[34] frequently referred to as H. R. 10 or the Keogh Bill. The Act applies to taxable years beginning after December 31, 1962. The objective of the Act is to permit self-employed individuals, including partners, to participate in, and obtain the benefits of, qualified pension and profit-sharing plans. The principal benefits of a qualified pension or profit-sharing plan are the deferral of income tax on contributions under such plans until distribution to the beneficiary occurs, and tax deferral, during the same period, on earnings from investment of the contributions. The Act extends these benefits, within certain specified limits, to self-employed individuals.

In general, the basic concept of the Act is to treat as employees, for pension and profit-sharing plan purposes, self-employed individuals who perform personal services. However, the Act makes a distinction between self-employed individuals owning more than 10 percent of the business and partners with a smaller ownership interest. Self-employed individuals who

31 76 Stat. 1158 (1962).

32 76 Stat. 1199 (1962).

33 *Supra*, note 2.

34 *Supra*, note 1.

own 10 percent or less of an unincorporated trade or business are treated substantially in the same manner as common law employees for the purpose of determining whether a plan which covers them qualifies for preferred tax treatment. Thus, the so-called "nondiscriminatory" rules applicable to common law employees are the main restrictions on the qualification of such plans.

On the other hand, plans covering self-employed individuals who have more than a 10 percent interest in the business have to satisfy additional requirements for qualification. Retirement plans covering these self-employed individuals, denominated by the Act as "owner-employees", are required, among other things, to provide comparable benefits for all full-time employees with more than three years of service. Contributions for such full-time employees must be fully vested at the time they are made. The distribution of an owner-employee's interest in a qualified retirement plan may not be made prior to his reaching age 59½, except in the case of death or permanent disability, and must be commenced upon his attainment of age 70½.

Qualified retirement plans covering owner-employees may be funded in a number of ways.

1. There may be a trust. If the plan involves a trust, the trustee generally must be a bank.

2. In lieu of a trust, a custodial account in a bank is permitted if the investments of the funds are made solely in annuity, endowment, or life insurance contracts issued by a life insurance company, or solely in stock of an open-end regulated investment company.

3. The retirement plan may be funded through the purchase of annuity contracts (including variable annuities) directly from a life insurance company or through the purchase of face amount certificates directly from any company which issues such certificates.

4. Retirement plans may also be funded through the purchase of a new series of Government bonds which are authorized by the new law.

If endowment or other policies which include life insurance protection are used to fund a qualified retirement plan, no deduction is permitted for the portion of the premium which is allocable to the life insurance protection.

The Act also provides new rules as to the tax treatment of the interests of all self-employed individuals which are different from those applicable to employees' interests. The most significant of these rules is that lump sum distributions to self-employed individuals of their interests in qualified plans are not treated as long-term capital gains, instead these distributions are treated as ordinary income and given a special averaging treatment; and the estate and gift tax exclusions with respect to employees' interests under qualified plans are not extended to self-employed individuals.

Contributions to the plan during a taxable year on behalf of a self-employed individual who is an owner-employee are limited to 10 percent of his earned income for the taxable year or $2,500, whichever is the lesser, unless he establishes a contributory plan for his employees. In case of a contributory plan for employees, an owner-employee may under certain conditions contribute a maximum of $5,000 in a taxable year. Contributions on behalf of other self-employed individuals— that is, those who own 10 percent or less of their trade or business— are not restricted by these limitations, but may be made in greater amounts provided these contributions are in accordance with a nondiscriminatory plan. However, the limit on the amount of deductible contributions for a taxable year is the same for all self-employed individuals. It is the lesser of 10 percent of earned income or $2,500. Futhermore, only ½ of this amount is allowable as a deduction. Thus, in no event may the amount deducted for any taxable year for any self-employed individual exceed 5 percent of his earned income or $1,250, whichever is the lesser.

A few words of caution are appropriate at this point: A qualified plan requires a definite *written* plan incorporating the provisions needed to satisfy the requirements of the Code. Therefore, before establishing a retirement plan, the qualification requirements of the Act should be carefully considered. It is my opinion, therefore, that the wise course of action would be to "wait for the dust to settle", that is, to wait for some of the problems regarding this complex Act to be clarified. It should be borne in mind that the taxpayer will not suffer any disadvantage by waiting until the latter part of 1963 to establish and fund a qualified plan.

III.

Revenue Act of 1962

Investment Credit

Perhaps the most intriguing and challenging provision of the Revenue Act of 1962 is the investment credit.[35] In its simplest terms, the investment credit enables a tax payer to reduce his tax liability for the taxable year in which qualified depreciable property is placed in service by 7 percent of the cost of the property. Public utilities are limited to a 3 percent credit. The basis of qualified property must be reduced by the amount of the credit.

The major points of consideration under this supersimplified outline of the credit include (1) the limitations on the amount of the credit allowable in any one taxable year, the carrybacks and carryovers of unused credits, and the basis adjustment; (2) the recapture;(3)the election of a lessor to pass the credit to the lessee; and (4) the definition of qualified new and used property. A brief discussion of these points, with special emphasis on the definition of qualified property, follows:

(1) *Limitation on credit, the carryback and carryover of unused credits, and the basis adjustment.* A taxpayer's credit for any one year may in no event exceed $25,000, plus 25 percent of a taxpayer's liability for tax in excess of $25,000. However, a 3-year carryback and a 5-year carryover are provided for any credit which goes unused because of this limitation. The basis of qualified property must be reduced by the credit. Thus, to the extent of the credit, depreciation deductions will be reduced. It should be noted that a basis adjustment for the full amount

[35] Sec. 2, Rev. Act 1962, 76 Stat. 962.

of the credit must be made irrespective of the fact that the credit is not used to offset tax in the year the property is placed in service. If any part of the credit is unused after the application of the carryback and carryover provisions, a special deduction for the unused portion of the credit is provided.

(2) *Recapture.* Where property is disposed of prior to the end of its useful life as estimated for the credit, the credit is to be reduced to the amount which would have been allowable on the basis of the period during which the property was actually held by the taxpayer as qualified property. This has been referred to as the recapture provision. Exceptions to the recapture are provided for death, section 381 transactions (generally corporate reorganizations), and changes in form of doing business, such as, the incorporation of a partnership. The recapture provision prevents possible abuses. If the recapture provision serves to reduce the taypayer's credit, the basis adjustment is reversed to the extent of the reduction in the credit.

(3) *Election for leased property.* A lessor of new qualified property, if he so elects, may pass the credit directly to the lessee, if the lessee consents. If an election is made, the lessee is treated as the owner of the property for all purposes of the credit, including recapture, and the lessor need not reduce the basis of the leased property; instead the lessee is required to decrease his rental deductions by an amount equal to the credit.

(4) (a) *New and used property.* The credit applies to both new and used depreciable property acquired after December 31, 1961, and is applicable to taxable years ending after December 31, 1961. However, only $50,000 of used property placed in service in a taxable year will qualify.

(b) *Qualified property.* The heart of the credit lies in the definition of qualified property. To begin with, the property must have an estimated useful life of 4 years or more. This life is to be estimated without regard to the depreciation reform, contained in Revenue Procedure 62-21. Thus, for purposes of the credit, the useful life is the useful life of the particular property to the taxpayer—the broad class life concept contained in the reform is not relevant. To avoid a bias in favor of shortlived property, only 1/3 and 2/3 of the cost of qualified property with a useful life of between 4 to 6 and 6 to 8 years, respectively, is eligible for the 7 percent credit. The total cost of qualified property with a useful life of 8 years or more is eligible for the 7 percent credit. Special rules are provided for determining cost in case of trade-ins and other special situations.

With few exceptions, all *tangible depreciable personal* property with the requisite 4 year life qualifies. This category of qualified property, tangible personal property, is by far the most important. In this connection, the very vital point to remember is that local law definitions will not govern. A "Federal" concept will govern the definition of personal property, and this will be quite broad. In fact, it will be so broad that all machinery and equipment, affixed to a building and held to be real property under State law, will nevertheless qualify for the credit.

Other tangible depreciable property (not including buildings and structural components of buildings) will also qualify if such property is used as an integral part of a manufacturing, production, or extraction process, or as an integral part of a system of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services. Thus, such vital properties as blast furnaces, brick kilns, railroad tracks, and oil and gas pipelines will qualify for the credit if they are used as an integral part of the specified process or system. Also, a research or storage facility used in connection with one of the above-mentioned processes or systems will qualify. Since a building and its structural components do not qualify, structural components, such as pipes, wiring, and ducts, are not entitled to the credit.

Certain property is specifically excluded from the credit. Such property includes:

(1) Property used predominantly outside the United States, except property, such as aircraft and vessels, which by their nature are used outside the United States;

(2) Property which is used predominantly to furnish lodging, except property used by a hotel or motel;

(3) Property used by a tax-exempt organization, unless the property is used in a taxable unrelated trade or business;

(4) Property used by a governmental unit; and

(5) Livestock.

Temporary regulations relating to certain aspects of the investment credit were published in the Federal Register for November 20, 1962.

Gain From Dispositions of Certain Depreciable Property

The Revenue Act of 1962 adds a new section 1245 to the Code which provides, in general, that gain upon any disposition of certain depreciable property (referred to as section 1245 property) in a taxable year beginning after December 31, 1962, will be taxed as ordinary income to the extent of depreciation taken in respect of the property in any period after December 31, 1961. Section 1245 property, in general, includes (1) all depreciable personal property (other than livestock) and (2) depreciable tangible property (other than a building or its structural components) used as an integral part of manufacturing or certain other processes or systems, including research or storage facilities used in connection therewith. Unless a specific exception applies, the excessive depreciation will be recaptured as ordinary income even upon a disposition which was not taxed prior to enactment of the new section, such as a distribution by a corporation of depreciable property in liquidation or as a dividend.

Exceptions to the general rule of recapture are made in the case of transfers at death, gifts, and (except to the extent of any "boot") certain tax-free transactions, such as reorganizations, like-kind exchanges, and involuntary conversions. However, in these cases (other than death) any depreciation reflected in the adjusted basis of property is subject to recapture even if the depreciation was taken by another taxpayer in respect of different property. Also, the deduction for a charitable contribution of depreciable property will be reduced by the amount of depreciation which would have been recaptured if the property had been sold at its fair market value.

The Act also provides that, for purposes of determining the basis for depreciation, salvage value of personal property acquired after October 16, 1962, with a useful life of at least 3 years may be reduced by 10 percent of cost.

Information Reporting on Dividends, Interest, and Patronage Dividends

The Revenue Act of 1962 contains provisions requiring persons making payments of dividends, interest, or patronage dividends to file information returns with respect to such payments. Under these provisions corporations making payments of dividends, interest, or patronage dividends aggregating $10 or more in any calendar year to any person are required to file an information return with the Internal Revenue Service, showing the total amount of the payments to the person and the name of the person. In addition, statements showing the total amount of payments are required to be furnished to the recipients of the dividends, interest, or patronage dividends. These statements must be furnished on or before January 31 of the year following the calendar year in which the payments were made. These provisions are, in general, applicable to payments made after December 31, 1962. Proposed regulations relating to information reporting were published in the Federal Register for November 7, 1962.[36]

Travel and Entertainment

New Code section 274, added by the Revenue Act of 1962, makes two major changes in the law affecting the deductibility of expenses for travel and entertainment. Section 274 provides that a taxpayer shall not be allowed any deduction for such expenses unless the taxpayer substantiates such expenses by adequate records or by other sufficient evidence corroborating the taxpayer's own statement. This new provision supersedes the well known doctrine of the *Cohan*[37] case, which permitted deductions based on reasonable approximations of expenses. The substantiation rules are also applicable to business gifts.

The proposed regulations on the new substantiation rules, published in the Federal Register for November 8, 1962, set out

[36] *Editor's note.* The final regulations relating to information reporting are contained in Treasury Decision 6628 published in the Federal Register for December 28, 1962.

[37] *Cohan v. Commissioner*, 39 F. 2d 540 (2d Cir., 1930).

the proposed guidelines for taxpayers to follow in keeping records which will be considered sufficient to substantiate any claimed deduction for travel and entertainment. The proposed regulations provide in effect that the requirement of adequate records will be satisfied if the taxpayer maintains:

(1) An account book, diary, or other statement of expense in a contemporaneous and consistent manner throughout the taxable year, showing itemized information as to cost, time, place and business purpose of any expenditure for travel or entertainment, and the business relationship to the taxpayer of persons entertained; and

(2) Documentary evidence, such as itemized receipts or itemized paid bills, for all expenditures of $10 or more.

Public hearings have just been concluded on the proposed regulations, and consideration is now being given as to whether this dollar amount should be changed in the final regulations. The Commissioner has also announced that certain provisions of the proposed regulations will be liberalized when they are issued in final form.[38]

In addition to the new rule requiring substantiation of claimed deductions for travel and entertainment expenses, new Code section 274 imposes certain restrictions on the deductibility of such expenses, which are in addition to those imposed by other provisions of the Code, such as section 162, relating to ordinary and necessary business expenses, and section 212, relating to expenses for the production of income.

First, section 274 provides the general rule that an expenditure for entertainment is not deductible unless it is *directly related* to the active conduct of the taypayer's trade or business. This means that the taxpayer must show that the expense has a proximate relation to his business. The taxpayer must show that the entertainment expense was incurred for more than a general expectation of deriving income at an indefinite future time. It means, speaking generally, that in order to be deductible the expense must be incurred under circumstances

[38] *Editor's note.* The final regulations relating to the new substantiation rules are contained in Treasury Decision 6630 published in the Federal Register for December 29, 1962.

conducive to business discussions. It means, again speaking generally, that entertainment expenses primarily for good will and expenses for family members not directly associated in the business are not deductible.

A special rule, however, applies if the entertainment expense is incurred directly preceding or following a substantial and bona fide business discussion. In this situation, the expense will be deductible under a more liberal rule—that is, if it is associated with the taxpayer's trade or business. Further, there are several specific exceptions from the new rule, including an exception for business meals.

Under a second general restriction imposed by section 274, no deduction will be allowed for expenses incurred with respect to an entertainment facility unless the facility is used primarily in furtherance of the taxpayer's trade or business and the expenditure is directly related to the active conduct of the trade or business.

Section 274 also provides new rules covering deductibility of expenses for travel away from home on business. If the trip is for one week or less, the taxpayer will, as heretofore, be able to deduct the full cost of his travel to and from his destination so long as the primary purpose of the trip is for business. However, if the trip is for over one week, unless the portion of time away from home attributable to business (or the production of income) exceeds 75 percent of the total time away from home, only that portion of the expenses which under regulations are allocable to business (or the production of income) will be allowable as a deduction and only if such expenses are otherwise allowable under section 162 or section 212.

Other related provisions limit deduction for meals and lodging while away from home to amounts not lavish or extravagant under the circumstances and limit deductions for business gifts, with limited exceptions, to an aggregate of $25 per donee per year.

Section 274 is applicable to taxable years ending after December 31, 1962, but only in respect of periods after that date.

Appearances with Respect to Legislation

The Revenue Act of 1962 provides a deduction for ordinary and necessary business expenses relating to appearances before, and communications with, a committee, or an individual member, of a Federal, State, or local legislative body, with respect to legislation or proposed legislation of direct interest to the taxpayer.[39] Also deductible are expenses of communications between an organization and its members and that portion of a member's dues which are attributable to the expenses of an activity of the described character. The provision is applicable to taxable years beginning after December 31, 1962.

Cooperatives, Mutual Savings Institutions, and Mutual Fire and Casualty Insurance Companies

The Revenue Act of 1962 makes basic changes in the method of taxing cooperatives and their patrons,[40] mutual savings institutions,[41] and mutual fire and casualty insurance companies.[42] In the case of cooperatives and their patrons, the Act provides that all of the earnings of cooperative organizations will be taxed currently either to the cooperatives or to their patrons. In the case of mutual savings institutions, the Act substantially reduces the amounts which such institutions may set aside as additions to their reserves for bad debts, thereby increasing their income tax liability. In the case of mutual fire and casualty insurance companies, the tax base is broadened by providing that these companies generally will be subject to tax on their underwriting income, as well as on their investment income.

Foreign Provisions

Several provisions contained in the Revenue Act of 1962 deal with the taxation of foreign source income.[43] Although these provisions deal with a diversity of subject matter, the

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[39] Sec. 3, Rev. Act 1962, 76 Stat. 973.

[40] Sec. 17, Rev. Act 1962, 76 Stat. 1045.

[41] Sec. 6, Rev. Act 1962, 76 Stat. 977.

[42] Sec. 8, Rev. Act 1962, 76 Stat. 989.

[43] Sec. 5, Rev. Act 1962, 76 Stat. 977; Sec. 7, Rev. Act 1962, 76 Stat. 985; Secs. 9-12, Rev. Act 1962, 76 Stat. 999; Secs. 14-16, Rev. Act 1962, 76 Stat. 1036. See also Sec. 18, Rev. Act 1962, 76 Stat. 1052; and Secs. 20 and 31, Rev. Act 1962, 76 Stat. 1059 and 1069.

effect of the provisions can be summed up by saying that they all attempt to put an end to flagrant abuse situations that had arisen when the rate structures and jurisdictional concepts of foreign countries for taxing income did not meet, or overlapped the rate structures and jurisdictional concepts of the United States for taxing income. Of course, taxpayers may not be unanimous in the feeling that all situations covered by the 1962 Act constituted abuses.

Time limitations and the complexity of many of the foreign provisions make it inadvisable to discuss, or even mention, the several provisions.

Other Provisions

The Revenue Act of 1962 also contains several other provisions of lesser importance or of more limited application. The scope of this paper precludes reference to these provisions.

THE DEDUCTIBILITY OF EDUCATIONAL EXPENSES UNDER §162(a) OF THE INTERNAL REVENUE CODE

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The Internal Revenue Code and the Commissioner's Regulations[1] allow as a deduction from Gross Income[2] educational expenses incurred by a taxpayer, within certain specific limits. The authority for such a deduction being a section of the Code dealing with deductions for the ordinary and necessary expenses of a trade or business, the case law and the Regulations relative to the deductibility of educational expenses have followed closely the developing concepts of "ordinary and necessary" business expenses.

Code § 162(a) provides that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ." The Regulations, in general, develop the theory

[1] INT. REV. CODE of 1954, § 162(a); Treas. Reg. § 1.162-5 (1958).

[2] INT. REV. CODE of 1954, § 62(1); Rev. Rul. 97, 1960-1 CUM. BULL. 69, 75.