

**GENERAL EXPLANATION  
OF THE  
REVENUE ACT OF 1978**

**(H.R. 13511, 95TH CONGRESS; PUBLIC LAW 95-600)**

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PREPARED BY THE STAFF OF THE  
JOINT COMMITTEE ON TAXATION



MARCH 12, 1979

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CONGRESS OF THE UNITED STATES  
(96th Cong., 1st Sess.)

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## LETTER OF TRANSMITTAL

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CONGRESS OF THE UNITED STATES,  
JOINT COMMITTEE ON TAXATION,  
Washington, D.C., March 12, 1979.

HON. AL ULLMAN, *Chairman*,  
HON. RUSSELL B. LONG, *Vice Chairman*,  
*Joint Committee on Taxation*,  
*U.S. Congress, Washington, D.C.*

DEAR MESSRS. CHAIRMEN: While committee reports explain the position of the House Committee on Ways and Means or the position of the Senate Committee on Finance, they do not in all cases explain the tax legislation which is finally passed by the Congress. This becomes particularly important in the case of major legislation in which there are many differences between the bill as passed by the House and as passed by the Senate, and the bill which finally becomes public law. The Revenue Act of 1978, because of its comprehensive scope and the many changes which were made in the House bill by the Senate and subsequently by the conferees, is an illustration of a case where the differences were especially significant.

This document represents the effort by the staff of the Joint Committee on Taxation to provide an explanation of the Revenue Act of 1978 as finally enacted and is comparable to a number of similar documents prepared by the staff on other revenue acts in recent years. For the most part, where provisions were unchanged in conference and described in either the House or Senate report, that explanation is used in this document. No attempt is made here to carry the explanation further than is customary in the case of committee reports; therefore, this explanation does not deal with issues which are customarily explained in regulations or rulings.

The first major part of the document provides the legislative history of the Revenue Act of 1978, including references to the sources of legislative history for provisions that were added as Senate amendments where there were separately reported bills on those provisions. The second part is a summary of the various provisions. The third part presents the general reasons for the legislation. The fourth part contains the revenue estimates on the legislation as finally enacted; and the fifth part is an explanation of the provisions in the order in which they appear in the public law.

This material was prepared by the staff of the Joint Committee on Taxation, with consultation with the staffs of the House Committee on Ways and Means and the Senate Committee on Finance, after the Revenue Act of 1978 was passed. It has not been reviewed by the tax committees, and therefore only reflects the staff's view as to the intent of Congress.

Sincerely yours,

BERNARD M. SHAPIRO,  
*Chief of Staff.*





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# I. LEGISLATIVE HISTORY OF REVENUE ACT OF 1978

## A. CHRONOLOGY OF THE ACT

The following is a chronology of the legislative history of the Revenue Act of 1978 (H.R. 13511; Public Law 95-600).<sup>1</sup>

- **House Committee on Ways and Means hearings on the President's 1978 tax reform and reduction proposals** (H.R. 12078 introduced as the Administration proposal)—January 30-31; February 1; March 6-10, 13-17, 20; April 3-7, and 24, 1978.
- **House Committee on Ways and Means markup on Administration's proposals**—April 17-20, 1978.
- **Introduction of H.R. 13511**—July 18, 1978.
- **House Committee on Ways and Means markup on H.R. 13511**—July 20, 25-27, 1978.
- **H.R. 13511 reported by House Committee on Ways and Means**—August 4, 1978 (House Report 95-1445).
- **House Committee on Rules**—hearing on August 8, 1978, and reported on August 9, 1978 (House Resolution 1306; House Report 95-1461).
- **House of Representatives floor action**—considered and passed on August 10, 1978.
- **H.R. 13511 referred to Senate Committee on Finance**—August 14, 1978.
- **Senate Committee on Finance hearings**—August 17, 21-25, and September 6, 1978.
- **Senate Committee on Finance markup**—September 7-8, 11-12, 14, 18-21, and 25-26, 1978.
- **H.R. 13511 reported by Senate Committee on Finance**—October 1, 1978 (Senate Report 95-1263).
- **Senate floor action**—October 5-7, and 9-10, 1978.
- **House-Senate conference on H.R. 13511**—October 12-15, 1978.
- **Conference report on H.R. 13511**—October 15, 1978 (House Report 95-1800).
- **House Committee on Rules action on conference report**—October 15, 1978 (House Resolution 1444; House Report 95-1802).
- **House and Senate agreed to conference report**—October 15, 1978.
- **H.R. 13511 signed by the President**—November 6, 1978 (Public Law 95-600).

<sup>1</sup> Title VII of the Act, which contains technical corrections to the Tax Reform Act of 1976, was considered as a separate bill, H.R. 6715, by the House of Representatives and Senate Committee on Finance. That bill was reported by the House Committee on Ways and Means on October 12, 1977, passed by the House of Representatives on October 17, 1977, and reported by the Senate Committee on Finance on April 17, 1978. The provisions of H.R. 6715, as approved by the Senate Finance Committee, were added to the Revenue Act of 1978, with several minor changes by a Senate floor amendment. The following portion of this part, *Sources of Legislative History*, provides references to the relevant committee reports for these provisions and for other provisions which were added to the Revenue Act of 1978 by the Senate and which were identical or similar to provisions contained in other bills reported separately in the 95th Congress. Footnotes in the text also refer to the appropriate House and Senate reports for these other tax bills, provisions of which were included in the Revenue Act of 1978.

## **B. SOURCES OF LEGISLATIVE HISTORY**

The principal sources of legislative history for the Revenue Act of 1978 (Public Law 95-600) are the reports of the House Committee on Ways and Means (House Report 95-1445), the Senate Committee on Finance (Senate Report 95-1263), and the Conference Committee (House Report 95-1800). A number of provisions of the Revenue Act of 1978 are identical or similar to provisions which were contained in other bills reported separately in the 95th Congress and which were added to the Act by the Senate. The references to other bills and committee reports relating to these provisions are set forth below.

(2)



TAX PROVISIONS INCLUDED IN THE REVENUE ACT OF 1978 WHICH WERE SEPARATELY REPORTED IN OTHER TAX BILLS  
IN THE 95TH CONGRESS

SECTION OF THE REVENUE ACT OF 1978	SUBJECT	BILL	COMMITTEE REPORT
1. Sec. 121.....	Child care credit for payments to related parties.	H.R. 8535.....	H. Rept. 95-1092.
2. Sec. 157.....	Individual retirement account technical changes.	H.R. 13619.....	H. Rept. 95-1739.
3. Sec. 163.....	Tax counseling for the elderly.	H.R. 3553.....	H. Rept. 95-1667.
4. Sec. 314.....	Investment credit for single purpose agricultural or horticultural structures.	H.R. 12846.....	H. Rept. 95-1761.
5. Sec. 317.....	Investment credit recapture under the ConRail reorganization.	H.R. 10653.....	H. Rept. 95-1539.
6. Sec. 333.....	Industrial development bonds for water facilities.	H.R. 10239.....	H. Rept. 95-1734.
7. Sec. 343.....	Extension of period for making subchapter S elections.	H.R. 7320 (Public Law 95-628).	H. Rept. 95-645; S. Rept. 95-797.
8. Sec. 362.....	Deficiency dividend procedure for regulated investment companies.	H.R. 6877.....	H. Rept. 95-1537.
9. Sec. 364.....	Contributions in aid of construction to regulated electric or gas public utilities.	H.R. 11741.....	H. Rept. 95-1577.
10. Sec. 368.....	Postponement of effective date for special limitations on net operating loss carryovers.	H.R. 9251 (Public Law 95-615).	H. Rept. 95-697; S. Rept. 95-746; H. Rept. 95-1798 (Conference).

TAX PROVISIONS INCLUDED IN THE REVENUE ACT OF 1978 WHICH WERE SEPARATELY REPORTED IN OTHER TAX BILLS  
IN THE 95TH CONGRESS—Continued

SECTION OF THE REVENUE ACT OF 1978	SUBJECT	BILL	COMMITTEE REPORT
11. Sec. 369-----	Use of certain expired net operating loss carryovers and redemption of certificates of value in a tax-free reorganization of a transferor railroad.	H.R. 10653-----	H. Rept. 95-1539.
12. Sec. 370-----	Income from certain railroad rolling stock treated as from sources within the United States.	H.R. 12352-----	H. Rept. 95-1561.
13. Sec. 372-----	Accounting for magazines, paperbacks, and records returned after the close of the taxable year.	H.R. 3050-----	H. Rept. 95-1091; S. Rept. 95-1278.
14. Sec. 373-----	Accounting for qualified coupons redeemed after the close of the taxable year.	H.R. 13047-----	H. Rept. 95-1707.
15. Sec. 422-----	Minimum tax treatment of intangible drilling costs.	H.R. 5263 (Public Law 95-618). <sup>1</sup>	H. Rept. 95-435; S. Rept. 95-529; H. Rept. 95-1773 (Conference); S. Rept. 95-1324 (Conference).

16. Sec. 501-----	Reporting requirements with respect to charged tips.	H.R. 13592-----	H. Rept. 95-1679.
17. Sec. 502-----	Tax Court small tax case procedure and authority of the commissioners.	H.R. 13092-----	H. Rept. 95-1609.
18. Sec. 512-----	Attribution rules for extension of time to pay estate tax.	H.R. 12578(sec. 7)-	H. Rept. 95-1286.
19. Sec. 520-----	Reduction of excise tax on private foundation investment income.	H.R. 112-----	H. Rept. 95-842; S. Rept. 95-790.
20. Sec. 530-----	Employment tax status of individuals as independent contractors or employees.	H.R. 14159-----	H. Rept. 95-1748.
21. Sec. 540-----	Source of interest income on deposits in Puerto Rican branches of U.S. savings and loan associations.	H.R. 13758-----	H. Rept. 95-1745.
22. Secs. 701-703--	Technical Corrections to the Tax Reform Act of 1976.	H.R. 6715-----	H. Rept. 95-700; S. Rept. 95-745.

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<sup>1</sup> The Energy Tax Act of 1978. These energy tax provisions were reported by the Committee on Ways and Means as H.R. 6831 (H. Rept. 95-496, Part III) and by the House Ad Hoc Committee on Energy as H.R. 8444 (H. Rept. 95-543). H.R. 8444, including the energy tax provisions, was passed by the House and referred to the Senate Finance Committee. The Finance Committee reported the energy tax provisions on H.R. 5263, as amended (S. Rept. 95-529). H.R. 5263 was passed by the Senate with amendments and conference reports were filed on the House-Senate Conference agreement (H. Rept. 95-1773 and S. Rept. 95-1324).



## II. SUMMARY OF THE ACT

The Revenue Act of 1978 provided tax reductions to stimulate consumer and investment spending in order to increase economic growth. In addition, it contained many tax changes designed to improve the equity of the tax system and to simplify it.

### *Overview*

#### *Principal provisions*

The principal provisions of the Revenue Act of 1978 are the following:

- A reduction in individual income tax rates, a major element of an individual income tax reduction of approximately \$12.8 billion for calendar year 1979.

- A permanent tax rate reduction for corporations, amounting to \$5.1 billion for calendar year 1979.

- A major expansion of the earned income tax credit for the working poor, which will amount to \$1 billion in 1979. In addition, the credit is simplified and will be reflected in an employee's paychecks, rather than being paid out in one lump sum as a tax refund.

- An increase (beginning in 1979) in the zero bracket amount and the corresponding floor under itemized deductions (which had replaced the standard deduction) from \$2,200 to \$2,300 for single persons and heads of households, and from \$3,200 to \$3,400 for married couples.

- An increase in the personal exemption from \$750 to \$1,000 (beginning in 1979) to replace the expiring general tax credit.

- A doubling of the tax credit for political contributions and repeal of the itemized deduction for political contributions.

- Repeal of the itemized deduction for nonbusiness State and local gasoline taxes.

- A phaseout of the exclusion for unemployment compensation benefits at higher income levels.

- Changes to limit certain tax shelters.

- Rules for taxation of benefits under certain deferred compensation plans.

- An increase from 50 percent to 60 percent in the portion of long-term capital gains deductible from gross income.

- A once-in-a-lifetime election to exclude from taxable income the first \$100,000 of gain from the sale of a principal residence by taxpayers who are age 55 or older.

- Elimination of capital gains and adjusted itemized deductions from the list of tax preferences subject to the add-on minimum tax for individuals.

- A new alternative minimum tax at rates up to 25 percent on taxable income increased by the capital gains deduction and certain adjusted itemized deductions (generally, certain itemized deductions in excess of 60 percent of adjusted gross income), which individuals will

pay only if it exceeds their regular income tax. An exclusion for capital gain from the sale of a principal residence is provided.

- Repeal of the 25-percent alternative income tax on the first \$50,000 of long-term capital gain.
- A capital gains tax rate reduction for corporations.
- Deferral of carryover of basis at death until 1980.
- Denial of business deductions for use of certain entertainment facilities, such as yachts and hunting lodges.
- An expansion of the WIN-welfare tax credit to encourage both business and nonbusiness employers to hire WIN registrants and welfare recipients.
- A targeted jobs tax credit, to replace the general jobs tax credit, designed to encourage people to hire needy youths and other categories of people who frequently have difficulty finding jobs.
- A permanent 10-percent investment tax credit.
- Liberalization of the investment tax credit by raising the amount of tax liability which the credit may offset from 50 percent to 90 percent by 1982, extending it to rehabilitation of existing industrial and commercial buildings, and extending the full credit to certain pollution control facilities for which 5-year amortization is elected.
- Revised subchapter S rules.
- Additional funding of \$0.4 billion (a total of \$2.9 billion) for social services under Title XX of the Social Security Act for fiscal year 1979.
- A Congressional policy statement regarding the rate of growth in Federal outlays for fiscal years 1979-1983, and possible further income tax reduction.

#### *Overall revenue effect*

The Act provides new tax cuts of \$18.9 billion in calendar year 1979 and \$22.5 billion in 1980. The budget effect in fiscal year 1979, including both the new tax cuts and the extensions of expiring tax cuts, is a revenue reduction of \$19.3 billion.

Of the new tax cuts for 1979, \$12.8 billion represents cuts in individual income tax liabilities, \$3.7 billion represents business income tax cuts and \$2.2 billion represents reductions in capital gains taxes for individuals and corporations.<sup>1</sup> The remaining \$.2 billion in tax cuts for 1979 relate to certain excise and estate and gift tax changes.

#### *Individual Income Taxes*

The Revenue Act of 1978 provides three principal individual income tax cuts affecting virtually all taxpayers. The Act increases the personal exemption from \$750 to \$1,000 beginning in 1979. This increase in the exemption replaces the temporary general tax credit, which equaled the greater of \$35 for each exemption or 2 percent of the first \$9,000 of taxable income in excess of the zero bracket amount). The Act replaced the tax rate schedule, which had 25 brackets, with a new schedule with

<sup>1</sup> The revenue loss from the capital gains tax cut for individuals, except for the special provision for residences, is reduced by one-third (\$1 billion in calendar year 1979, \$1 billion in 1980, and \$0.1 billion in fiscal year 1979) to take account of the offsetting revenue gain expected from additional sales of appreciated assets resulting from the capital gains tax reduction.

15 wider brackets. Also, it increases the zero bracket amount and the corresponding floor under itemized deductions, which had replaced the old standard deduction, from \$2,200 to \$2,300 for single persons, and from \$3,200 to \$3,400 for married couples.

The Act significantly expands the earned income tax credit for the working poor. Previously, the credit was 10 percent of the first \$4,000 of earnings and was phased out as income rose between \$4,000 and \$8,000. Under the Act, the credit is 10 percent of the first \$5,000 of earnings (an increase in the maximum credit from \$400 to \$500), and the phaseout range is increased to between \$6,000 and \$10,000. The credit is also simplified so that it will be easier to compute. Finally, instead of being paid out as one lump sum upon filing a tax return for the taxable year, the credit will be reflected in employees' paychecks, making it a more effective work incentive and distributing the tax relief more evenly throughout the year. The credit is treated as earned income for purposes of determining eligibility for, and benefits under, certain Federal assistance programs. The tax cut and additional outlays from the increased earned income credit will amount to \$1 billion for 1979.

The Act repeals the deduction for nonbusiness State and local gasoline taxes in order to simplify preparation of individual tax returns.

In addition, the Act doubles the tax credit for political contributions to encourage wider political participation and, to simplify the income tax return, it repeals the alternative itemized deduction for political contributions.

### ***Business Taxes***

#### ***Corporate tax rate***

The Act provides a sizable reduction in the corporate income tax rate. The top corporate tax rate is reduced from 48 percent to 46 percent, and a system of graduated tax rates is established for small businesses. In place of rates of 20 percent on the first \$25,000 of taxable income, 22 percent on taxable income between \$25,000 and \$50,000, and 48 percent on taxable income in excess of \$50,000, the new rate schedule is 17 percent on the first \$25,000 of income, 20 percent on income between \$25,000 and \$50,000, 30 percent on income between \$50,000 and \$75,000, 40 percent on income between \$75,000 and \$100,000, and 46 percent on income above \$100,000. This tax reduction, amounting to about \$5 billion in 1979, is designed to increase business investment and encourage the formation and expansion of small businesses. About \$1 billion of the tax cut will be received by businesses with incomes below \$100,000.

#### ***Investment tax credit***

The Act makes permanent the existing 10-percent investment tax credit, as well as the \$100,000 limitation on the amount of used property eligible for the credit and extends for 3 years the extra investment credit for contributions to Tax Reduction Act employee stock ownership plans (TRASOP's). The availability of the credit is also liberalized by increasing the tax liability limitation from 50 percent to 90 percent on a phased-in basis. The credit is amended to clarify its application to single purpose agricultural structures. Also, the Act extended the investment credit to expenditures for rehabilitation of commercial

and industrial buildings. The full investment credit is extended to pollution control facilities for which the taxpayer has elected 5-year amortization. (These facilities received only one-half the normal investment credit under prior law.) There are also a number of technical amendments to the provision giving an extra investment credit to employers who contribute to employee stock ownership plans.

*Targeted jobs credit; WIN credit*

In place of the general jobs tax credit, which expired at the end of 1978, the Act increased the rate of the existing WIN-welfare recipient tax credit and provided a new targeted jobs credit to encourage businesses to hire needy youths and others who often have difficulty finding jobs even when the economy is prosperous. For trade or business employers who hire welfare recipients and WIN registrants, the WIN-welfare tax credit is 50 percent of the first \$6,000 of wages for the first year of employment and 25 percent for the second year. Businesses will not receive a deduction for wages equal to the amount of the credit. In addition, there is a 35-percent credit for the first year of employment for welfare recipients (limited to the first \$6,000 of wages per employee and \$12,000 total qualifying wages per employer) who are hired outside of a trade or business. The categories of people eligible for the new targeted jobs credit include needy youths, needy Vietnam-era veterans, SSI recipients, convicted felons, recipients of general assistance, certain handicapped individuals, and high school students in cooperative education programs. The credit is 50 percent of the first \$6,000 of wages for the first year of employment and 25 percent of such wages for the second year of employment. The expanded earned income credit and WIN and welfare credits were designed to increase the employment of people who are now on welfare, and the new targeted jobs credit was designed to help alleviate the serious unemployment problems of the covered groups.

*Entertainment facilities*

The Act denies a deduction for entertainment facilities, including yachts and hunting lodges, because generally these facilities are used mostly for personal reasons. Club dues are not covered under the new disallowance rules.

***Capital Gains and Minimum and Maximum Tax Provisions***

The Act contains a major reduction in the income tax on capital gains. This was designed to encourage greater investment in new and risky enterprises and to increase the mobility of capital by encouraging taxpayers to sell appreciated assets. Congress believed that these beneficial economic effects of the capital gains tax reduction would greatly reduce the revenue loss from the capital gains tax cut.

Specifically, the Act increases the percentage of long-term capital gains deductible from gross income from 50 percent to 60 percent, effective for sales after October 31, 1978. To ensure that this tax cut does not result in high-income individuals paying very low effective rates of tax, the Act imposes an alternative minimum tax on taxable income increased by the capital gains deduction and certain adjusted itemized deductions, with rates up to 25 percent. Individuals will pay this alternative minimum tax only if it exceeds their tax computed the



regular way. The 15-percent add-on minimum tax is continued from prior law except that it does not apply to capital gains deductions or adjusted itemized deductions. Neither the add-on nor alternative minimum tax applies with respect to a capital gain from the sale of a principal residence. Another significant capital gains tax change under the Act will allow an individual, who is at least age 55, to elect to exclude from income up to \$100,000 of any gain realized on the sale of his or her principal residence. However, this exclusion may be elected only once in a lifetime. The present rollover provision for gains on a principal residence where the proceeds of the sale are reinvested in another principal residence remains in effect.

The Act also removes capital gains from the tax preferences which reduce the amount of personal service income eligible for the 50-percent maximum tax.

The 50-percent maximum tax on personal service income is also liberalized by expanding the definition of earned income for businesses in which both capital and labor are used to produce income.

The Act also reduces the alternative corporate capital gains tax rate from 30 to 28 percent.

The application of the provision for carryover of basis at death, enacted in 1976, is deferred through the end of 1979.

### ***Tax-Exempt State and Local Government Bonds***

The Act makes a number of changes in the provisions relating to tax-exempt bonds. The elective \$5 million limit on small issues of industrial development bonds is raised to \$10 million and the limit on the amount of capital expenditures for the project is raised to \$20 million for urban development action grant facilities. The Act permits advance refundings for certain industrial development bonds used to finance certain public projects. The Act also includes a transitional rule to exempt certain bonds issued in connection with advanced refundings of certain exempt industrial development bonds. It exempts interest from industrial development bonds for certain water projects. The Act also contains provisions for the treatment of industrial development bonds issued in connection with the local furnishing of electric energy and advance refunding arbitrage profits where profits are donated to a public charity. The Act also provides judicial review for private letter rulings relating to the tax exempt status of proposed bond issues.

### ***Small Business Provisions***

In addition to the substantially lower corporate tax rates for the first \$100,000 of taxable income, the Act contains several provisions relating to small businesses. The Act liberalizes the rules for eligibility for subchapter S corporation treatment, which generally provides for the passthrough of income and losses to shareholders without the incidence of taxation at the corporate level. Also, the Act simplifies and liberalizes the provision which permits ordinary loss treatment (i.e., full deductibility) for investments in common stock of certain small business corporations.

### ***Employee Compensation and Retirement Plans***

The Act allows employees and independent contractors who perform services for a State or local government to defer annually an amount

equal to the lesser of \$7,500 or 33⅓ percent of their currently includible compensation. In addition, compensation deferred under unfunded deferred compensation plans maintained by taxable employers will be subject to the principles of law applying on February 1, 1978.

Under the Act, participants in nondiscriminatory "cafeteria" plans will not have taxable income to the extent they elect to receive nontaxable benefits. ("Cafeteria plans" are employee fringe benefit plans permitting participants to choose among fringe benefits they want purchased with employer contributions.)

Also, the Act provides rules under which participants in "cash or deferred" profit sharing plans can defer tax on amounts paid by their employers into the plan.

The Act provides for simplified pension plans.

The Act provides favorable treatment for a sale of an annuity contract by a life insurance company to a public employee retirement plan.

Under the Act, self-insured medical and accident reimbursement plans will be required not to discriminate in favor of officers, shareholders or highly compensated employees in order for those participants to obtain favorable tax treatment. In addition, if certain requirements are met, the value of educational assistance provided by employers under a nondiscriminatory plan would be excluded from an employee's income.

### ***Tax Shelter and Partnership Provisions***

The Act contains several changes designed to limit the use of tax shelters. The coverage of the provision limiting loss deductions to the amount a taxpayer is at risk (the at risk provision) is expanded from four specific activities (farming, oil and gas, motion pictures, and equipment leasing) to all activities except real estate. This provision is also extended to certain closely held corporations, and the separate partnership at risk provision is repealed.

The Act imposes civil penalties for failure to file and late filing of partnership tax returns. In addition, partners of partnerships subject to the registration and reporting requirements of the Securities and Exchange Commission will now be subject to a four-year statute of limitations with respect to partnership income, deductions and credits flowed through to the partners.

### ***Other Tax Provisions***

The Act exempts from corporate income tax State-chartered corporations set up as general stock ownership corporations (GSOs) for the residents of any State. Under these plans, the shareholders of the corporation (i.e., all residents of the State) would be taxed currently on their pro rata share of the corporation's taxable income in a manner similar to shareholders of subchapter S corporations.

The Act provides a deficiency dividend procedure for mutual funds similar to that provided for real estate investment trusts.

Under the Act, contributions in aid of construction to regulated gas and electric utilities are treated as nontaxable contributions to capital (the same treatment previously given to water and sewer utilities).

Current law regarding employer reporting of tip income is extended.

The 4-percent excise tax on investment income of private foundations is reduced to 2 percent. The existing excise tax credit for State taxes paid on coin operated slot machines is increased from 80 percent to 95 percent for 1979 and 1980, and the Federal tax is repealed entirely thereafter.

The Act extends the exclusion for amounts received by participants in the Armed Forces health professions scholarship program and the Public Health Service/National Health Service Corps scholarship program, pending a study of these issues.

Also, the Act extends through 1982 the moratorium on taxation of certain student loan cancellations.

The Act postpones for two years the effective date of the rules adopted in the Tax Reform Act of 1976 relating to trafficking in net operating loss carryovers.

The Act extends for 3 years the 5-year amortization of expenditures for rehabilitation of low-income housing.

The Act provides relief through 1979 for taxpayers involved in controversies with the IRS about employment tax status reclassifications of workers whom the taxpayers had not considered to be their employees.

It expands the exception to the source rules for interest on deposits in foreign branches of U.S. commercial banks to interest on deposits with Puerto Rican branches of U.S. savings and loan associations.

The Act provides a safe harbor rule for real estate investment trusts from the tax on prohibited transactions.

The Act extends the family corporation exception to the rules requiring the accrual method of accounting and capitalization of pre-productive period expenses by farm corporations to certain two- and three-family corporations. In addition, there are changes in accounting rules for sod farms, florists, nurseries and certain other farmers.

The estate tax rules are changed to exclude a portion of the value of jointly owned property from a decedent's gross estate in recognition of the participation by a surviving spouse in the joint operation of a farm or other business.

There is an exemption from the investment credit recapture rules for the bankrupt railroads which transferred property to ConRail and there are changes in the net operating loss carryover rules as they apply to transferors of property to ConRail.

The Act provides for Treasury Department studies of the tax treatment of foreign owners of U.S. real estate, of the appropriate depreciation or amortization of equipment required by occupational health and safety (OSHA) or mine safety (MSHA) regulations, and of simplification of income tax returns for individuals.

The Act also expands the volunteer income tax assistance program of the Internal Revenue Service by authorizing the IRS to enter into training and technical assistance agreements with nonprofit agencies to prepare volunteers to provide tax counseling to elderly individuals.

Further, the Act includes various technical, clerical, and conforming amendments to the Tax Reform Act of 1976.

## ***Amendments Relating to the Social Security Act***

### *Grants to States for social services*

The Act extends the temporary \$200 million additional amount available to States for social services under title XX of the Social Security Act for one more year—through fiscal year 1979. As was the case in fiscal years 1977 and 1978, this \$200 million is to be available only for child care and requires no non-Federal matching; this amount is to be allocated on a population basis. The Act also provides a further \$200 million increase in the ceiling for fiscal 1979 which is available for social services generally and subject to the ordinary matching requirements of title XX.

The net effect of this provision is to raise the ceiling on Federal funding for title XX social services to \$2.9 billion for fiscal year 1979. After fiscal year 1979, the ceiling will revert to its permanent level of \$2.5 billion in the absence of further legislation.

### *Public assistance matching for Puerto Rico, the Virgin Islands, and Guam in fiscal year 1979*

The Act increases the matching rate and ceilings in fiscal 1979 for public assistance programs for Puerto Rico, the Virgin Islands, and Guam. The matching rate is increased from 50 percent to 75 percent, up to a maximum amount of Federal funding for the fiscal year of \$72 million in Puerto Rico, \$2.4 million in the Virgin Islands, and \$3.3 million in Guam. In the absence of further legislation, the matching rate and limitations will revert to their permanent-law levels after fiscal year 1979.

### ***Policy with Respect to Additional Tax Reductions***

The Act also contains the following congressional policy statement regarding Federal outlays and possible future tax reductions:

“As a matter of national policy the rate of growth in Federal outlays, adjusted for inflation, should not exceed 1 percent per year between fiscal year 1979 and fiscal year 1983; Federal outlays as a percentage of gross national product should decline to below 21 percent in fiscal year 1980, 20.5 percent in fiscal year 1981, 20 percent in fiscal year 1982 and 19.5 percent in fiscal year 1983; and the Federal budget should be balanced in fiscal years 1982 and 1983. If these conditions are met, it is the intention that the tax-writing committees of Congress will report legislation providing significant tax reductions for individuals to the extent that these tax reductions are justified in the light of prevailing and expected economic conditions.”

### III. GENERAL REASONS FOR THE ACT

Congress believed that a major tax reduction for both individuals and business was needed to maintain the vigor of the current economic recovery and to compensate for tax increases which would otherwise occur in 1979. Tax reductions for individuals were considered necessary to offset the increase in social security taxes which was enacted in 1977 and which takes effect in 1979, as well as the automatic tax increase that will result from the inflation expected during 1978 and 1979. Tax reductions for business and capital gains tax reductions were considered necessary to stimulate investment, which was considered inadequate during the last five years.

In addition, Congress believed it was appropriate to review the tax system periodically to see whether it is having the appropriate impact on the economy and whether tax burdens are in accordance with taxpayers' ability to pay. The Act was part of that periodic review. Furthermore, Congress was concerned about the complexity of the tax system. Specific tax changes in the Act were designed to make the tax system more equitable, simpler, and more conducive to economic efficiency and growth. The following discussion covers the general reasons for the major areas of the Act: individual income taxes, business taxes, and capital gains and the minimum tax.

#### *Individual Income Taxes*

In deciding on the appropriate level and distribution of individual income tax reductions, Congress took into account the expected tax increases in 1979 from inflation and from the legislated social security tax increases. While it was impossible to give every individual taxpayer a tax cut large enough to compensate for these tax increases, Congress structured the individual income tax cuts so that almost every income class will receive a tax cut large enough to compensate for the inflation and social security tax increases in 1979 over 1978.

Congress concluded that the appropriate size of the income tax cut in 1979 liabilities for individuals was \$12.8 billion. This amount of tax reduction for individuals was believed to strike the appropriate balance between the need to keep consumer spending at a level high enough to maintain the vigor of the economic recovery and the conflicting need to bring the Federal budget into balance by the early 1980's.

Congress also believed that the individual income tax should be as simple as possible, and several of the individual income tax changes in the Act are designed to help achieve this goal. These changes include the substitution of a \$1,000 personal exemption for the complicated general tax credit, the repeal of the itemized deduction for nonbusiness State and local gasoline taxes, and the repeal of the itemized deduction for political contributions (while doubling the credit for such contributions).

### ***Business Taxes***

Congress believed that a substantial business tax cut was necessary to stimulate business investment in plant and equipment, which is the key to improving productivity, reducing the rate of inflation, and improving the balance of trade. While consumer spending is substantially above its peak prior to the 1973-75 recession, it is only recently that investment spending has attained its pre-recession peak. Furthermore, an increasing portion of investment is needed to meet Federally mandated requirements under environmental, occupational health and safety, and other laws. Because of these regulations and because the labor force growing rapidly, Congress concluded that the rate of growth of investment must be higher than in the past to achieve the same rate of growth of productivity.

Testimony presented to the Congress strongly suggested that the most effective way to increase business investment was a reduction in the corporate tax rate. The 48-percent top corporate tax rate had not been reduced since 1964. In addition, to provide help to small businesses, a 5-step graduated rate structure was provided to replace the 3-step rate structure under prior law.

Another major concern of Congress with respect to business taxes was the need to provide incentives to encourage businesses to hire the hard-core unemployed—people who have trouble finding jobs even when the economy is prosperous. In 1977, Congress enacted a temporary jobs tax credit to encourage increased hiring. Since then, the unemployment rate had fallen from above 7 percent to below 6 percent, and the problem in 1978 was not so much general unemployment but rather structural unemployment. Therefore, Congress concluded that the general jobs tax credit should be allowed to expire at the end of 1978, and should be replaced by an expanded WIN-welfare tax credit and a new targeted jobs tax credit directed toward categories of people with chronic unemployment problems. Congress believed that the targeted jobs credit and the expanded WIN-welfare tax credit will provide a strong incentive for businesses to hire the hard-core unemployed and should make a major contribution to reducing unemployment in the years ahead.

### ***Capital Gains and the Minimum Tax***

Congress believed that the capital gains treatment under prior law was counter-productive in the sense that it could discourage investment and sales of appreciated assets to such an extent that it did not provide as much revenue as would result from lower capital gains tax rates. In addition, the prior rules regarding capital gains, which involved a regular tax, a minimum tax, an alternative tax and a maximum tax, were believed to be unnecessarily complex. As a result, the Act included a major restructuring of the tax on capital gains and the prior minimum and maximum taxes.

The main feature of this restructuring was an increase from 50 percent to 60 percent in the amount of capital gains deductible from gross income. Congress believed that this tax cut will encourage additional sales of appreciated assets and that the tax revenue from these unlocked capital gains will be sufficient to offset much of the revenue

loss from the tax cut and possibly lead to an actual revenue increase. In addition, Congress concluded that the improved mobility of capital and increased after-tax profitability of potential investments will lead to a substantial increase in investment activity.

Although the decrease in capital gains taxes was intended to stimulate investment activity, Congress did not approve of situations in which individuals take advantage of the law to escape income taxation entirely. The add-on minimum tax alone was not considered an adequate response to this problem; it provided too high a tax on people paying substantial amounts of regular income tax, and it provided too little tax on taxpayers paying very little regular income tax. Thus, the Act removed the preferences for capital gains and adjusted itemized deductions under the add-on minimum tax and provided an alternative minimum tax based on taxable income increased by the amount of long-term capital gains deductions and adjusted itemized deductions. Taxpayers will pay this alternative minimum tax, the top rate of which will be 25 percent, only if it exceeds their regular income tax. The Act also provides an exclusion for capital gains from the sale of a principal residence under the new alternative minimum tax.





## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT

**Table I-1.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83\***

### *Part A. Tax Reductions and Revisions*

[Millions of dollars]

Provision	Calendar year liabilities				
	1979	1980	1981	1982	1983
<b>Title I—Individual Income Tax Provisions</b>					
<i>A. Individual income tax reductions and extensions:</i>					
Secs. 101 and 106—Widening tax brackets, rate cuts, increase in zero bracket amount.....	-11,735	-13,873	-16,428	-19,482	-23,137
Repeal general tax credit.....	10,397	10,985	11,618	12,302	13,039
Sec. 102—Increase in the personal exemption.....	-11,681	-12,382	-13,125	-13,913	-14,747
Secs. 104 and 105—Increase in and simplification of the earned income credit <sup>a</sup> .....	-1,029	-987	-949	-910	-873
<i>B. Itemized deductions; unemployment compensation; credits:</i>					
Sec. 111—Repeal of nonbusiness deduction for State and local taxes on gasoline and other motor fuels..	1,151	1,358	1,602	1,890	2,231
Sec. 112—Taxation of unemployment compensation benefits at certain income levels.....	251	261	259	263	268
Sec. 113—Political contributions.....	-20	-33	-20	-20	-20
Sec. 121—Child care credit for payments to related individuals.....	-35	-36	-37	-38	-39
<i>C. Deferred compensation provisions:</i>					
Sec. 131—State and local government deferred compensation plans.....	(4)	(4)	(4)	(4)	(4)
Sec. 132—Certain private deferred compensation plans.....					
Sec. 133—Deferred compensation payments to independent contractors.....					

\*The revenue estimates in Part A are the tax reductions from levels which would have prevailed had the existing temporary tax cuts been extended. Thus, where the bill merely extends an expiring tax cut, the table does not show any revenue effect; and where the bill replaces an expiring tax cut with a new provision (such as substituting graduated corporate tax rates for the corporate surtax exemption), the revenue loss from the new provision is only the excess of its gross revenue loss over what the revenue loss would have been had the expiring provision been extended. A revenue gain is shown for failing to extend the general tax credit and general jobs tax credit. Part B shows the revenue losses which would have occurred had certain existing temporary tax provisions been extended through 1983, both the provisions actually extended in the bill and the provisions replaced by other provisions.

(Other footnotes are at the end of the table.)

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-1.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

*Part A. Tax Reductions and Revisions—Continued*

[Millions of dollars]

Provision	Calendar year liabilities				
	1979	1980	1981	1982	1983
<b>Title I—Individual Income Tax Provisions—Continued</b>					
<i>D. Employee stock ownership plans:</i>					
Sec. 142—Estate tax exclusion for certain lump sum distributions-----	(1)	(1)	(1)	(1)	(1)
Sec. 143—Voting rights on employer securities for qualified plans-----	(1)	(1)	(1)	(1)	(1)
<i>E. Retirement plan provisions:</i>					
Sec. 152—Simplified employee pensions-----	-15	-25	-35	-45	-55
Sec. 153—Defined benefit plan limits-----	(2)	(2)	(2)	(2)	(2)
Sec. 154—Custodial accounts for regulated investment company stock-----	(2)	(2)	(2)	(2)	(2)
Sec. 155—Pension plan reserves-----	(2)	(2)	(2)	(2)	(2)
Sec. 156—Rollover of distributions from a tax-sheltered annuity-----	(2)	(2)	(2)	(2)	(2)
Sec. 157—Individual retirement account technical changes-----	-12	-12	-12	-12	-12
<i>F. Other individual tax provisions:</i>					
Sec. 161(a)—Uniformed Services Health Professions Scholarships-----	(2)	(2)	(2)	(2)	(2)
Sec. 161(b)—National Research Service Awards-----	-18	-10	(2)	-----	-----
Sec. 162—Cancellation of student loans-----	(2)	(2)	(2)	(2)	(2)
Sec. 164—Employer educational assistance-----	-26	-29	-32	-36	-40
<b>Total, Title I-----</b>	<b>-12,772</b>	<b>-14,783</b>	<b>-17,159</b>	<b>-20,001</b>	<b>-23,385</b>
<b>Title II—Tax Shelter and Partnership Provisions</b>					
<i>Tax shelter provisions:</i>					
Sec. 201—Extension of at risk rules to all activities other than real estate-----	10	7	6	4	4
Sec. 202—Extension of at risk provisions to closely held corporations-----	3	2	1	1	2
Sec. 203—Recapture of losses where amount at risk is less than zero-----	(1)	(1)	(1)	(1)	(1)
<b>Total, Title II-----</b>	<b>13</b>	<b>9</b>	<b>7</b>	<b>5</b>	<b>6</b>

Footnotes at end of table.

## V. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-1.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

## Part A. Tax Reductions and Revisions—Continued

[Millions of dollars]

Provision	Calendar year liabilities				
	1979	1980	1981	1982	1983
<b>Title III—Provisions Primarily Affecting Business Income Tax</b>					
<i>Corporate rate reduction:</i>					
Sec. 301—Corporate rate reduction	-5,069	-5,551	-6,078	-6,655	-7,288
<i>Investment credit provisions:</i>					
Sec. 312—Increase in limitation to 90 percent of tax liability	-287	-629	-1,169	-826	-728
Sec. 313—Increased investment credit for certain pollution control facilities	-8	-25	-53	-91	-112
Sec. 314—Investment credit for single purpose agricultural or horticultural structures	-22	-22	-23	-25	-27
Sec. 315—Investment credit for certain rehabilitated buildings	-166	-193	-210	-229	-249
Sec. 316—Investment credit for co-operatives	-33	-34	-36	-38	-40
Sec. 317—Investment credit recapture under the Conrail reorganization					
<i>Targeted jobs credit; WIN credit:</i>					
Sec. 321—Targeted jobs credit	-388	-608	-705	-86	-86
Sec. 322—Work incentive program (WIN) credit changes	-106	-177	-216	-248	-296
Repeal of general jobs credit	2,458	2,458	2,458	2,458	2,458
<i>Tax-exempt bonds; Industrial development bond provisions:</i>					
Sec. 331—Increase in limit on small issues	-2	-11	-21	-32	-43
Sec. 332—Local furnishing of electric energy	-2	-8	-14	-21	-26
Sec. 333—Industrial development bonds for water facilities	-5	-24	-46	-68	-95
Sec. 334—Advance refunding of industrial development bonds for certain public projects	(2)	(2)	(2)	(2)	(2)
<i>Small business corporation provisions:</i>					
Secs. 341-343—Subchapter S corporation provisions	(1)	(1)	(1)	(1)	(1)
Sec. 345—Small business corporation stock	(2)	(2)	(2)	(2)	(2)

Footnotes at end of table.

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-1.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

*Part A. Tax Reductions and Revisions—Continued*

[Millions of dollars]

Provision	Calendar year liabilities				
	1979	1980	1981	1982	1983
<b>Title III—Provisions Primarily Affecting Business Income Tax—Continued</b>					
<i>F. Farm accounting rules:</i>					
Sec. 351—Treatment of certain closely held farm corporations for accrual accounting purposes-----	(2)	(2)	(2)	(2)	(2)
Sec. 352—Accounting for growing crops-----	(2)	(2)	(2)	(2)	(2)
Sec. 353—Treatment of certain farms for purposes of rule requiring accrual accounting-----	(2)	(2)	(2)	(2)	(2)
<i>G. Other business tax provisions:</i>					
Sec. 361—Entertainment facility expenses-----	28	30	33	36	40
Sec. 362—Deficiency dividend procedure for regulated investment companies-----	(1)	(1)	(1)	(1)	(1)
Sec. 363—Safe harbor rule for Real Estate Investment Trusts-----	(5)	(5)	(5)	(5)	(5)
Sec. 364—Contributions in aid of construction to regulated electric or gas public utilities <sup>a</sup> -----	-96	-98	-101	-103	-107
Sec. 365—Liabilities of controlled corporations-----	(2)	(2)	(2)	(2)	(2)
Sec. 366—Medical expense reimbursement plans-----	(2)	(2)	(2)	(2)	(2)
Sec. 368—Postponement of effective date for special limitations on net operating loss carryovers-----	(2)	(2)	(2)	(2)	(2)
Sec. 369—Use of certain expired net operating loss carryovers and redemption of certificates of value in a tax-free reorganization of a transferor railroad-----	(1)	(1)	(1)	(1)	(1)
Sec. 371—Product liability net operating losses-----	-2	-10	-10	-9	-9
Sec. 372—Accounting for magazine, paperbacks, and records returned after the close of the taxable year-----		-11	-12	-13	-14
Sec. 373—Accounting for qualified coupons redeemed after the close of the taxable year-----	-10	-10	-10	-10	-10
<b>Total, Title III-----</b>	<b>-3,710</b>	<b>-4,923</b>	<b>-6,213</b>	<b>-5,960</b>	<b>-6,632</b>

Footnotes at end of table.

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-1.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

*Part A. Tax Reductions and Revisions—Continued*

[Millions of dollars]

Provision	Calendar year liabilities				
	1979	1980	1981	1982	1983
<b>Title IV—Capital Gains; Minimum Tax; Maximum Tax</b>					
<i>A. Capital gains provisions:</i>					
Sec. 401—Repeal of alternative tax for noncorporate capital gains.....	133	143	154	166	178
Sec. 402—Increased capital gains deduction for individuals.....	-1, 763	-1, 895	-2, 037	-2, 190	-2, 354
Sec. 403—Reduction of corporate alternative capital gains tax.....	-117	-135	-148	-163	-177
Sec. 404—One-time exclusion of gain on sale of residence.....	-415	-457	-502	-552	-607
Sec. 405—Rollover of gain on sale of residence incident to a job-related move.....	-4	-4	-4	-4	-4
Tax increase from induced capital gains realizations <sup>7</sup> .....	573	535	445	286	128
<i>B. Minimum tax provisions:</i>					
Sec. 421—Repeal certain preferences in the minimum tax.....	-1, 274	-1, 401	-1, 541	-1, 695	-1, 865
Sec. 421—Alternative minimum tax for individuals.....	739	813	894	984	1, 082
Sec. 422—Minimum tax treatment of intangible drilling costs.....	( <sup>8</sup> )	( <sup>8</sup> )	( <sup>8</sup> )	( <sup>8</sup> )	( <sup>8</sup> )
Sec. 423—Amendment to definition of foreign source capital gain tax preference.....	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
<i>C. Maximum tax provision:</i>					
Sec. 441—Capital gain tax preference offset.....	-52	-57	-63	-69	-76
Sec. 442—Limitation on personal service income.....	-56	-65	-75	-86	-99
<b>Total, Title IV.....</b>	<b>-2, 236</b>	<b>-2, 523</b>	<b>-2, 877</b>	<b>-3, 323</b>	<b>-3, 794</b>

**Title V—Other Tax Provisions***A. Administrative provisions:*

Sec. 501—Reporting requirements with respect to charged tips.....	( <sup>9</sup> )	( <sup>9</sup> )	( <sup>9</sup> )	( <sup>9</sup> )	( <sup>9</sup> )
Sec. 504—Refund adjustments for amounts held under claim of right..	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )

*B. Estate and gift tax provisions:*

Sec. 511—Jointly owned farms and closely held businesses.....	-41	-43	-46	-48	-51
Sec. 512—Attribution rules for extension of time to pay estate tax....	( <sup>1</sup> )	( <sup>1</sup> )	( <sup>1</sup> )	( <sup>1</sup> )	( <sup>1</sup> )

Footnotes at end of table.

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-1.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

*Part A. Tax Reductions and Revisions—Continued*

[Millions of dollars]

Provision	Calendar Year Liabilities				
	1979	1980	1981	1982	1983
<b>Title V—Other Tax Provisions—Con.</b>					
<i>B. Estate and gift tax provisions—Con.</i>					
Sec. 513—Subordination of special liens for estate tax attributable to special valuation property-----	(1)	(1)	(1)	(1)	(1)
Sec. 514—Time to amend governing instruments of charitable split interest trusts-----					
Sec. 515—Deferral of carryover basis rules-----	-93	-162	-185	-190	-200
<i>C. Excise tax provisions:</i>					
Sec. 520—Reduction of excise tax on private foundation investment income-----	-40	-40	-40	-40	-40
Sec. 521—Excise tax on certain gaming devices-----	-4	-6	-7	-7	-7
Sec. 522—Treatment of certain private foundations for purposes of section 4942-----	(1)	(1)	(1)	(1)	(1)
<i>D. Other tax provisions:</i>					
Sec. 530—Employment tax status of individuals as independent contractors or employees-----	(10)	(10)	(10)		
Sec. 531—Tax treatment of cooperative housing corporations-----	(2)	(2)	(2)	(2)	(2)
Sec. 540—Source of interest income on deposit in Puerto Rican branches of U.S. savings and loan associations-----	(2)	(2)	(2)	(2)	(2)
Sec. 541—Taxation of Alaskan Native Claims Settlement Act Corporations-----	(11)	(11)	(11)	(11)	(11)
Sec. 542—Involuntary conversion of livestock-----	(2)	(2)	(2)	(2)	(2)
Sec. 543—Exclusion for certain cost-sharing payments-----	-17	-72	-72	-73	-74
<b>Total, Title V-----</b>	<b>-195</b>	<b>-323</b>	<b>-350</b>	<b>-358</b>	<b>-372</b>
<b>Title VI—General Stock Ownership Corporations-----</b>					
	(12)	(12)	(12)	(12)	(12)
<b>Title VII—Technical Corrections to the Tax Reform Act of 1976-----</b>					
		(2)	-7	-10	-13
<b>Total, Titles I-VII-----</b>	<b>-18,900</b>	<b>-22,543</b>	<b>-26,599</b>	<b>-29,647</b>	<b>-34,190</b>

Footnotes at end of table.

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-1.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

*Part B. Revenue Effects of Extending or Making Permanent Temporary Income Tax Reduction Provisions*

[Millions of dollars]

Provision	Calendar year liabilities				
	1979	1980	1981	1982	1983
<b>Individual Income Taxes</b>					
Per capita credit <sup>13</sup> -----	-6,449	-6,642	-6,842	-7,047	-7,258
Optional taxable income credit <sup>13</sup> -----	-3,949	-4,344	-4,778	-5,256	-5,782
Earned income credit-----	-1,061	-1,019	-978	-938	-900
Sec. 311—Investment tax credit at 10-percent rate-----			-722	-773	-829
Sec. 367—Amortization for low-income housing-----	(1)	-4	-9	-13	-16
Jobs tax credit <sup>14</sup> -----	-983	-983	-983	-983	-983
<b>Total, individual</b> -----	<b>-12,442</b>	<b>-12,992</b>	<b>-14,312</b>	<b>-15,010</b>	<b>-15,768</b>
<b>Corporation Income Taxes</b>					
Rate reductions-----	-2,060	-2,255	-2,470	-2,704	-2,961
Sec. 311—Investment tax credit at 10-percent rate-----			-4,000	-5,201	-5,894
Sec. 141—TRASOP investment credit at 1½-percent rate-----			-396	-508	-592
Sec. 367—Amortization for low-income housing-----	(1)	-3	-6	-9	-11
Jobs tax credit <sup>14</sup> -----	-1,475	-1,475	-1,475	-1,475	-1,475
<b>Total, corporate</b> -----	<b>-3,535</b>	<b>-3,733</b>	<b>-8,347</b>	<b>-9,897</b>	<b>-10,933</b>
<b>Total, Temporary Tax Reduction Extensions</b> -----	<b>-15,977</b>	<b>-16,725</b>	<b>-22,659</b>	<b>-24,907</b>	<b>-26,701</b>
<b>GRAND TOTAL, PARTS A AND B: TAX REDUCTIONS, REVISIONS AND EXTENSIONS</b> -----	<b>-34,877</b>	<b>-39,268</b>	<b>-49,258</b>	<b>-54,554</b>	<b>-60,891</b>

<sup>1</sup> Less than \$1 million.<sup>2</sup> Less than \$5 million.<sup>3</sup> This estimate includes both the reduction in revenues and increase in outlays from the changes in the earned income credit. The Congressional Budget Office estimates that these changes will reduce revenues by \$36, \$91, \$48, \$50, and \$55 million and outlays would be increased by \$198, \$965, \$782, \$786, and \$792 million in calendar years 1979-1983.<sup>4</sup> These provisions continue the existing tax treatment of these types of plans, within certain limitations, and therefore have a negligible effect on budget receipts.<sup>5</sup> No direct revenue effect is expected.<sup>6</sup> The estimates were derived assuming that the position taken by the IRS is the correct one. The figures do not allow for revenue effects of additional charges the utilities may make in order to get reimbursement for the additional taxes payable under IRS ruling.

Footnotes continued on next page.

<sup>7</sup> The revenue effect from induced capital gains realizations agrees with that from the Congressional Budget Office. Using the Senate Finance Committee methodology, the additional revenue would be \$738, \$799, \$864, \$934, and \$1,011 million for calendar years 1979-1983.

<sup>8</sup> The revenue loss of this provision has been included in H.R. 5263, the Energy Tax Act of 1978.

<sup>9</sup> This provision has the effect of overturning Revenue Rulings 75-400 and 76-231. If the employer reporting requirements contained in these rulings were to take effect, increases in budget receipts could be substantial. This revenue is not being collected at the present time; therefore, no change in budget receipts is estimated.

<sup>10</sup> The revenue effect cannot be estimated because the provision affects liabilities being contested by taxpayers in administrative and judicial proceedings.

<sup>11</sup> The liabilities cannot be estimated before the contested issues are settled by the courts.

<sup>12</sup> There is not enough information to predict what the responses of the many governmental units will be with respect to this bill. However, this proposal is not expected to have a significant revenue effect over the next few years.

<sup>13</sup> These items are not extended by H.R. 13511, but are allowed to expire after 1978 and are replaced by an increase in the personal exemption from \$750 to \$1,000.

<sup>14</sup> The expiring general jobs tax credit is not extended and an offsetting entry is shown in part A of this table.



## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-2.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Fiscal Year Receipts 1979-83\*

*Part A. Tax Reductions and Revisions*

[Millions of dollars]

Provision	Fiscal year receipts				
	1979	1980	1981	1982	1983
<b>Title I—Individual Income Tax Provisions</b>					
<i>A. Individual income tax reductions and extensions:</i>					
Secs. 101 and 106—Widening tax brackets, rate cuts, increase in zero bracket amount-----	-7,317	-13,057	-15,453	-18,317	-21,742
Repeal general tax credit-----	7,278	10,809	11,428	12,097	12,818
Sec. 102—Increase in the personal exemption <sup>3</sup> -----	-8,177	-12,171	-12,902	-13,677	-14,497
Secs. 104 and 105—Increase in and simplification of the earned income credit-----	-82	-1,227	-976	-937	-900
<i>B. Itemized deductions; unemployment compensation; credits:</i>					
Sec. 111—Repeal of nonbusiness deduction for State and local taxes on gasoline and other motor fuels-----	471	1,237	1,458	1,720	2,029
Sec. 112—Taxation of unemployment compensation benefits at certain income levels-----		251	261	259	263
Sec. 113—Political contributions-----		-20	-33	-20	-20
Sec. 121—Child care credit for payments to related individuals-----	-5	-38	-39	-40	-39
<i>C. Deferred compensation provisions:</i>					
Sec. 131—State and local government deferred compensation plans-----	(4)	(4)	(4)	(4)	(4)
Sec. 132—Certain private deferred compensation plans-----					
Sec. 133—Deferred compensation payments to independent contractors-----					

\* The revenue estimates in Part A are the tax reductions from levels which would have prevailed had the existing temporary tax cuts been extended. Thus, where the bill merely extends an expiring tax cut, the table does not show any revenue effect; and where the bill replaces an expiring tax cut with a new provision (such as substituting graduated corporate tax rates for the corporate surtax exemption), the revenue loss from the new provision is only the excess of its gross revenue loss over what the revenue loss would have been had the expiring provision been extended. A revenue gain is shown for failing to extend the general tax credit and general jobs tax credit. Part B shows the revenue losses which would have occurred had certain existing temporary tax provisions been extended through 1983, both the provisions actually extended in the bill and the provisions replaced by other provisions.

(Other footnotes are at the end of the table.)

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-2.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

*Part A. Tax Reductions and Revisions—Continued*

[Millions of dollars]

Provision	Fiscal year receipts				
	1979	1980	1981	1982	1983
<i>Title I—Individual Income Tax Provisions—Continued</i>					
<i>D. Employee stock ownership plans:</i>					
Sec. 142—Estate tax exclusion for certain lump sum distributions.....	(1)	(1)	(1)	(1)	(1)
Sec. 143—Voting rights on employer securities for qualified plans.....	(1)	(1)	(1)	(1)	(1)
<i>E. Retirement plan provisions:</i>					
Sec. 152—Simplified employee pensions.....	-6	-18	-29	-39	-49
Sec. 153—Defined benefit plan limits.....	(2)	(2)	(2)	(2)	(2)
Sec. 154—Custodial accounts for regulated investment company stock.....	(2)	(2)	(2)	(2)	(2)
Sec. 155—Pension plan reserves.....	(2)	(2)	(2)	(2)	(2)
Sec. 156—Rollover of distributions from a tax-sheltered annuity.....	(2)	(2)	(2)	(2)	(2)
Sec. 157—Individual retirement account technical changes.....	-25	-12	-12	-12	-12
<i>F. Other individual tax provisions:</i>					
Sec. 161(a)—Uniformed Services Health Professions Scholarships.....	(2)	(2)	(2)	(2)	(2)
Sec. 161(b)—National Research Service Awards.....	-52 <sup>5</sup>	-18	-10	(2)	-----
Sec. 162—Cancellation of student loans.....	(2)	(2)	(2)	(2)	(2)
Sec. 164—Employer educational assistance.....	-18	-28	-31	-35	-39
<b>Total, Title I.....</b>	<b>-7, 933</b>	<b>-14, 292</b>	<b>-16, 338</b>	<b>-19, 001</b>	<b>-22, 188</b>
<i>Title II—Tax Shelter and Partnership Provisions</i>					
<i>Tax shelter provisions:</i>					
Sec. 201—Extension of at risk rules to all activities other than real estate.....	1	10	7	6	4
Sec. 202—Extension of at risk provisions to closely held corporations.....	1	3	2	1	1
Sec. 203—Recapture of losses where amount at risk is less than zero.....	(1)	(1)	(1)	(1)	(1)
<b>Total, Title II.....</b>	<b>2</b>	<b>13</b>	<b>9</b>	<b>7</b>	<b>5</b>

Footnotes at end of table.

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-2.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

*Part A. Tax Reductions and Revisions—Continued*

[Millions of dollars]

Provision	Fiscal year receipts				
	1979	1980	1981	1982	1983
<b>Title III—Provisions Primarily Affecting Business Income Tax</b>					
<i>A. Corporate rate reduction:</i>					
Sec. 301—Corporate rate reduction	-2, 281	-5, 286	-5, 788	-6, 338	-6, 940
<i>B. Investment credit provisions:</i>					
Sec. 312—Increase in limitation to 90 percent of tax liability	-129	-441	-872	-1, 015	-782
Sec. 313—Increased investment credit for certain pollution control facilities	-6	-18	-42	-76	-104
Sec. 314—Investment credit for single purpose agricultural or horticultural structures	-53 <sup>5</sup>	-33 <sup>5</sup>	-22	-24	-26
Sec. 315—Investment credit for certain rehabilitated buildings	-67	-181	-205	-222	-238
Sec. 316—Investment credit for co-operatives	-20	-33	-35	-37	-39
Sec. 317—Investment credit recapture under the Conrail reorganization	-3 <sup>5</sup>				
<i>C. Targeted jobs credit; WIN credit:</i>					
Sec. 321—Targeted jobs credit	-141	-483	-651	-426	-86
Sec. 322—Work incentive program (WIN) credit changes	-39	-136	-197	-234	-264
Repeal of general jobs credit	689	2, 458	2, 458	2, 458	2, 458
<i>D. Tax-exempt bonds—Industrial development bond provisions:</i>					
Sec. 331—Increase in limit on small issues	(1)	-3	-14	-26	-37
Sec. 332—Local furnishing of electric energy	(1)	-3	-10	-18	-23
Sec. 333—Industrial development bonds for water facilities	(1)	-7	-31	-59	-78
Sec. 334—Advance refunding of industrial development bonds for certain public projects (sec. 335)	(2)	(2)	(2)	(2)	(2)
<i>E. Small business corporation provisions:</i>					
Sec. 341-343—Subchapter S corporation provisions	(1)	(1)	(1)	(1)	(1)
Sec. 345—Small business corporation stock	(2)	(2)	(2)	(2)	(2)

Footnotes at end of table.

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-2.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

*Part A. Tax Reductions and Revisions—Continued*

[Millions of dollars]

Provision	Fiscal year receipts				
	1979	1980	1981	1982	1983
<b>Title III—Provisions Primarily Affecting Business Income Tax—Continued</b>					
<i>F. Farm accounting rules:</i>					
Sec. 351—Treatment of certain closely held farm corporations for accrual accounting purposes-----	(2)	(2)	(2)	(2)	(2)
Sec. 352—Accounting for growing crops-----	(2)	(2)	(2)	(2)	(2)
Sec. 353—Treatment of certain farms for purposes of rule requiring accrual accounting-----	(2)	(2)	(2)	(2)	(3)
<i>G. Other business tax provisions:</i>					
Sec. 361—Entertainment facility expenses-----	13	29	31	34	38
Sec. 362—Deficiency dividend procedure for regulated investment companies-----	(1)	(1)	(1)	(1)	(1)
Sec. 363—Safe harbor rule for Real Estate Investment Trusts-----	(6)	(6)	(6)	(6)	(6)
Sec. 364—Contributions in aid of construction to regulated electric or gas public utilities <sup>7</sup> -----	(2)	-50	-100	-100	-100
Sec. 365—Liabilities of controlled corporations-----	(2)	(2)	(2)	(2)	(2)
Sec. 366—Medical expense reimbursement plans-----		(2)	(2)	(2)	(2)
Sec. 368—Postponement of effective date for special limitations on net operating loss carryovers-----	(2)	(2)	(2)	(2)	(2)
Sec. 369—Use of certain expired net operating loss carryovers and redemption of certificates of value in a tax-free reorganization of a transferor railroad-----	(1)	(1)	(1)	(1)	(1)
Sec. 371—Product liability net operating losses-----	(1)	(2)	-7	-8	-9
Sec. 372—Accounting for magazines, paperbacks, and records returned after the close of the taxable year-----		-5	-11	-12	-13
Sec. 373—Accounting for qualified coupons redeemed after the close of the taxable year <sup>8</sup> -----		-103	-10	-10	-10
<b>Total, Title III-----</b>	<b>-2,037</b>	<b>-4,295</b>	<b>-5,506</b>	<b>-6,113</b>	<b>-6,253</b>

Footnotes at end of table.

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

Table I-2.—Estimated Revenue Effects of Tax Provisions of the Revenue  
*Part A. Tax Reductions and Revisions—Continued*

[Millions of dollars]

Provision	Fiscal year receipts				
	1979	1980	1981	1982	1983
<b><i>Title IV—Capital Gains; Minimum Tax; Maximum Tax</i></b>					
<i>A. Capital gains provisions:</i>					
Sec. 401—Repeal of alternative tax for noncorporate capital gains-----	20	133	143	154	166
Sec. 402—Increased capital gains deduction for individuals-----	-131	-1,763	-1,895	-2,037	-2,190
Sec. 403—Reduction of corporate alternative capital gains tax-----	-53	-125	-141	-155	-170
Sec. 404—One-time exclusion of gain on sale of residence-----	-165	-415	-457	-502	-552
Sec. 405—Rollover of gain on sale of residence incident to a job-related move-----	-3	-4	-4	-4	-4
Tax increase from induced capital gains realizations <sup>9</sup> -----	68	573	535	445	286
<i>B. Minimum tax provisions:</i>					
Sec. 421—Repeal certain preferences in the minimum tax-----	-1,274	-1,401	-1,541	-1,695	
Sec. 421—Alternative minimum tax for individuals-----		739	813	894	984
Sec. 422—Minimum tax treatment of intangible drilling costs-----	( <sup>10</sup> )	( <sup>10</sup> )	( <sup>10</sup> )	( <sup>10</sup> )	( <sup>10</sup> )
Sec. 423—Amendment to definition of foreign source capital gain tax preference-----	-5 <sup>5</sup>	( <sup>1</sup> )	( <sup>1</sup> )	( <sup>1</sup> )	( <sup>1</sup> )
<i>C. Maximum tax provisions:</i>					
Sec. 441—Capital gain tax preference offset-----	-6	-52	-57	-63	-69
Sec. 442—Limitation on personal service income-----	-21	-59	-69	-79	-91
<b>Total, Title IV-----</b>	<b>-296</b>	<b>-2,247</b>	<b>-2,533</b>	<b>-2,888</b>	<b>-3,335</b>
<b><i>Title V—Other Tax Provisions</i></b>					
<i>A. Administrative provisions:</i>					
Sec. 501—Reporting requirements with respect to charged tips-----	( <sup>11</sup> )	( <sup>11</sup> )	( <sup>11</sup> )	( <sup>11</sup> )	( <sup>11</sup> )
Sec. 504—Refund adjustments for amounts held under claim of right-----	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )

Footnotes at end of table.

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-2.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Calendar Year Liabilities 1979-83—Continued

*Part A. Tax Reductions and Revisions—Continued*

[Millions of dollars]

Provision	Fiscal year receipts				
	1979	1980	1981	1982	1983
<b>Title V—Other Tax Provisions—Con.</b>					
<i>B. Estate and gift tax provisions:</i>					
Sec. 511—Jointly owned farms and closely held businesses.....	(1)	—41	—43	—46	—48
Sec. 512—Attribution rules for extension of time to pay estate tax....	(1)	(1)	(1)	(1)	(1)
Sec. 513—Subordination of special liens for estate tax attributable to special valuation property.....	(1)	(1)	(1)	(1)	(1)
Sec. 514—Time to amend governing instruments of charitable split interest trusts.....	—15 <sup>5</sup>	-----	-----	-----	-----
Sec. 515—Deferral of carryover basis rules.....	—36	—93	—162	—185	—190
<i>C. Excise tax provisions:</i>					
Sec. 520—Reduction of excise tax on private foundation investment income.....	—40	—40	—40	—40	—40
Sec. 521—Excise tax on certain gaming devices.....	—5 <sup>5</sup>	—6	—7	—7	—7
Sec. 522—Treatment of certain private foundations for purposes of section 4942.....	(1)	(1)	(1)	(1)	(1)
<i>D. Other tax provisions:</i>					
Sec. 530—Employment tax status of individuals as independent contractors or employees.....	(12)	(12)	(12)	-----	-----
Sec. 531—Tax treatment of cooperative housing corporations.....	(2)	(2)	(2)	(2)	(2)
Sec. 540—Source of interest income on deposit in Puerto Rican branches of U.S. savings and loan associations.....	(2)	(2)	(2)	(2)	(2)
Sec. 541—Taxation of Alaskan Native Claims Settlement Act Corporations.....	(13)	(13)	(13)	(13)	(13)
Sec. 542—Involuntary conversion of livestock.....	(2)	(2)	(2)	(2)	(2)
Sec. 543—Exclusion for certain cost-sharing payments.....	-----	—28	—77	—78	—79
<b>Total, Title V.....</b>	<b>—96</b>	<b>—208</b>	<b>—329</b>	<b>—356</b>	<b>—364</b>
<b>Title VI—General Stock Ownership Corporations.....</b>					
	(14)	(14)	(14)	(14)	(14)
<b>Title VII—Technical Corrections to the Tax Reform Act of 1976.....</b>					
	—8	-----	(1)	—7	—10
<b>Total, Titles I-VII.....</b>	<b>—10,368</b>	<b>—21,029</b>	<b>—24,697</b>	<b>—28,358</b>	<b>—32,145</b>

Footnotes at end of table.

## IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Cont.

Table I-2.—Estimated Revenue Effects of Tax Provisions of the Revenue Act of 1978 (H.R. 13511), Fiscal Year Receipts 1979–83—Continued

*Part B. Revenue Effect of Extending or Making Permanent Temporary Income Tax Reduction Provisions*

[Millions of dollars]

Provision	Fiscal year receipts				
	1979	1980	1981	1982	1983
<b>Individual Income Taxes</b>					
Per capita credit <sup>15</sup> -----	-4,514	-6,583	-6,780	-6,984	-7,194
Optional taxable income credit <sup>16</sup> -----	-2,764	-4,226	-4,648	-5,113	-5,624
Sec. 103—Extension of earned income credit-----		-1,061	-1,019	-978	-938
Sec. 311—Investment tax credit at 10-percent rate-----			-271	-741	-794
Sec. 367—Amortization for low-income housing-----	( <sup>1</sup> )	-2	-6	-11	-14
Jobs tax credit <sup>16</sup> -----	-125	-983	-983	-983	-983
<b>Total, individual</b> -----	<b>-7,403</b>	<b>-12,855</b>	<b>-13,707</b>	<b>-14,810</b>	<b>-15,547</b>
<b>Corporation Income Taxes</b>					
Rate reductions-----	-927	-2,148	-2,352	-2,575	-2,819
Sec. 311—Investment tax credit at 10-percent rate-----			-1,800	-4,460	-5,489
Sec. 141—TRASOP investment credit at 1½-percent rate-----			-178	-446	-545
Sec. 367—Amortization for low-income housing-----	( <sup>1</sup> )	-2	-5	-8	-10
Jobs tax credit <sup>16</sup> -----	-564	-1,475	-1,475	-1,475	-1,475
<b>Total, corporate</b> -----	<b>-1,491</b>	<b>-3,625</b>	<b>-5,810</b>	<b>-8,964</b>	<b>-10,338</b>
<b>Total, Temporary Tax Reduction Extensions</b> -----	<b>-8,894</b>	<b>-16,480</b>	<b>-19,517</b>	<b>-23,774</b>	<b>-25,885</b>
<b>GRAND TOTAL, PARTS A AND B: TAX REDUCTIONS, REVISIONS AND EXTENSIONS</b> -----	<b>-19,262</b>	<b>-37,509</b>	<b>-44,214</b>	<b>-52,132</b>	<b>-58,030</b>

<sup>1</sup> Less than \$1 million.<sup>2</sup> Less than \$5 million.<sup>3</sup> This estimate includes both the reduction in revenues and increase in outlays from the changes in the earned income credit. The Congressional Budget Office estimates that these changes will reduce revenues by \$19, \$113, \$48, \$51, and \$54 million and outlays would be increased by \$100, \$1,071, \$788, \$790, and \$791 million in fiscal years 1979–1983.<sup>4</sup> These provisions continue existing tax treatment of these types of plans, within certain limitations, and therefore have a negligible effect on budget receipts.<sup>5</sup> Includes liabilities of prior years.<sup>6</sup> No direct revenue effect is expected.<sup>7</sup> The estimates were derived assuming that the position taken by the IRS is the correct one. The figures do not allow for revenue effects of additional charges the utilities may make in order to get reimbursement for the additional taxes payable under IRS ruling.

<sup>8</sup> It is assumed the Service's position will be upheld by the courts in 1980.

<sup>9</sup> The revenue effect from induced capital gains realizations agrees with that from the Congressional Budget Office. Using the Senate Finance Committee methodology, the additional revenue would be \$37, \$738, \$799, \$864, and \$934 million for fiscal years 1979-1983.

<sup>10</sup> The revenue loss of this provision has been included in H.R. 5263, The Energy Tax Act of 1978.

<sup>11</sup> This provision has the effect of overturning Revenue Rulings 75-400 and 76-231. If the employer reporting requirements contained in these rulings were to take effect, increases in budget receipts could be substantial. This revenue is not being collected at the present time; therefore, no change in budget receipts is estimated.

<sup>12</sup> The revenue effect cannot be estimated because the provision affects liabilities being contested by taxpayers in administrative and judicial proceedings.

<sup>13</sup> Settlement of the contested issues is not expected to result in a significant impact on budget receipts through 1983.

<sup>14</sup> There is not enough information to predict what the responses of the many governmental units will be with respect to this bill. However, this proposal is not expected to have a significant revenue effect over the next few years.

<sup>15</sup> These items are not extended by H.R. 13511, but are allowed to expire after 1978 and are replaced by an increase in the personal exemption from \$750 to \$1,000.

<sup>16</sup> The expiring general jobs tax credit is not extended and an offsetting entry is shown in part A of this table.



# IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Continued

**Table I-3.—Distribution of Individual Income Tax Provisions<sup>1</sup> of the Revenue Act of 1978 (H.R. 13511)  
(1978 Income Levels)**

Expanded Income <sup>2</sup> (thousands)	Tax decrease			Tax increase			Net tax change		
	Returns (thou- sands)	Amount (mil- lions)	Average	Returns (thou- sands)	Amount (mil- lions)	Average	Amount (millions)	Percent of total	Percent of present law tax
Below \$5.....	5, 503	—\$210	—\$38	55	\$1	\$25	—\$208	1. 6	36. 0
\$5 to \$10.....	17, 431	—1, 557	—89	426	5	12	—1, 552	11. 6	18. 8
\$10 to \$15.....	13, 227	—1, 055	—80	613	9	15	—1, 045	7. 8	6. 1
\$15 to \$20.....	11, 366	—1, 543	—136	208	3	16	—1, 540	11. 6	6. 4
\$20 to \$30.....	12, 916	—3, 086	—239	18	1	54	—3, 085	23. 1	6. 9
\$30 to \$50.....	5, 824	—2, 669	—458	8	2	219	—2, 667	20. 0	6. 8
\$50 to \$100.....	1, 424	—1, 643	—1, 153	4	5	1, 264	—1, 638	12. 3	6. 8
\$100 to \$200.....	294	—657	—2, 235	5	19	3, 830	—638	4. 8	4. 9
\$200 and over.....	75	—1, 031	—13, 691	3	76	29, 834	—956	7. 2	7. 0
Total.....	68, 060	—13, 451	—198	2, 338	121	91	—13, 330	100. 0	7. 2

<sup>1</sup> Includes the earned income credit, increase in the zero bracket amount, bracket widening, rate reductions, \$1,000 personal exemption, repeal of the general tax credit, repeal of the gas tax deduction, capital gains changes except the principal residence exclusion, and the maximum, minimum, and alternative tax changes.

<sup>2</sup> Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

# IV. REVENUE EFFECTS OF TAX PROVISIONS OF THE ACT—Continued

**Table I-4.—Federal Individual Income Tax Burden\* for a Single Person and Married Couples With No, 1, 2, and 4 Dependents**

(Assuming Deductible Personal Expenses of 23 Percent of Income)

Income**	Tax liability														
	Single person			Married couple with no dependents			Married couple with 1 dependent			Married couple with 2 dependents			Married couple with 4 dependents		
	Under present law	Under H.R. 13511	Reduction	Under present law	Under H.R. 13511	Reduction	Under present law	Under H.R. 13511	Reduction	Under present law	Under H.R. 13511	Reduction	Under present law	Under H.R. 13511	Reduction
\$3,000-----	0	0	0	0	0	0	-300	-300	0	-300	-300	0	-300	-300	0
\$5,000-----	279	250	29	0	0	0	-300	-500	200	-300	-500	200	-300	-500	200
\$6,000-----	449	422	27	115	84	31	-200	-500	300	-200	-500	300	-200	-500	300
\$8,000-----	810	787	23	431	374	57	273	-26	299	120	-166	286	0	-250	250
\$10,000-----	1,199	1,177	22	761	702	59	620	534	86	446	374	72	128	84	44
\$12,500-----	1,631	1,585	46	1,186	1,152	34	1,059	972	87	917	792	125	562	454	108
\$15,000-----	2,126	2,047	79	1,651	1,625	27	1,486	1,415	72	1,330	1,233	97	990	873	117
\$17,500-----	2,660	2,547	114	2,075	2,029	46	1,910	1,819	91	1,745	1,609	136	1,385	1,220	165
\$20,000-----	3,232	3,115	117	2,555	2,457	98	2,368	2,223	145	2,180	2,013	167	1,808	1,593	215
\$25,000-----	4,510	4,364	146	3,570	3,399	171	3,360	3,141	219	3,150	2,901	249	2,738	2,421	317
\$30,000-----	5,950	5,718	232	4,712	4,477	235	4,472	4,197	275	4,232	3,917	315	3,778	3,357	421
\$35,000-----	7,500	7,220	281	6,002	5,705	297	5,732	5,385	347	5,464	5,065	399	4,954	4,435	519
\$40,000-----	9,233	8,886	347	7,427	7,052	375	7,135	6,682	453	6,848	6,312	536	6,278	5,657	621
\$50,000-----	12,985	12,559	426	10,610	10,183	427	10,273	9,753	520	9,950	9,323	627	9,290	8,463	827
\$60,000-----	16,835	16,392	443	14,230	13,602	628	13,856	13,112	744	13,496	12,634	862	12,746	11,774	972
\$70,000-----	20,685	20,242	443	18,080	17,375	705	17,705	16,885	820	17,330	16,395	935	16,550	15,415	1,135
\$80,000-----	24,535	24,092	443	21,930	21,178	752	21,555	20,678	877	21,180	20,178	1,002	20,400	19,188	1,212
\$90,000-----	28,385	27,942	443	25,780	25,028	752	25,405	24,528	877	25,030	24,028	1,002	24,250	23,038	1,212
\$100,000-----	32,235	31,792	443	29,630	28,878	752	29,255	28,378	877	28,880	27,878	1,002	28,100	26,878	1,222

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NOTE.—Details may not add to totals because of rounding.

\*Computed without reference to the tax tables.

\*\*Wage or salary and/or self-employment income.

## **V. GENERAL EXPLANATION OF THE REVENUE ACT OF 1978**

### **Policy With Respect to Additional Tax Reductions (sec. 3 of the Act)**

#### ***Prior law***

Prior law did not contain any provision concerning congressional policy relating tax changes to government spending levels.

#### ***Reasons for change***

Congress is concerned about the rapid increase in Federal spending. The Federal Government is absorbing too large a portion of our national production, and the large and continuing deficits are contributing to our seriously high inflation rate. Consequently, Congress believes it is appropriate to reduce the growth of Federal spending and achieve a balanced budget gradually over several years. If the rate of growth of Federal spending is constrained, there will be sufficient revenue generated by a growing economy to finance additional tax reductions.

The Congress believes that it is unrealistic to expect Federal spending not to grow as the economy and population grow and that some growth in real outlays beyond the rate of inflation is also to be expected. The Congress believes that it is unrealistic and economically irresponsible first to cut taxes and hope that this will then lead to expenditure reductions. The Congress also believes that making tax reductions automatic upon the achievement of spending goals several years in the future is excessively restrictive and ignores the uncertainties concerning the economic situation that far in advance which may necessitate different policies.

The Congress concluded that the best way to deal with these competing considerations is to make a firm statement of congressional policy concerning expenditure restraint and to combine this with a statement of congressional intent to accompany expenditure restraint with future tax reductions.

#### ***Explanation of provision***

The Act provides that, as a matter of national policy, the rate of growth in Federal outlays, adjusted for inflation, should not exceed 1 percent per year between fiscal year 1979 and fiscal year 1983; Federal outlays as a percentage of gross national product should decline to below 21 percent in fiscal year 1980, 20.5 percent in fiscal year 1981, 20 percent in fiscal year 1982, and 19.5 percent in fiscal year 1983; and the Federal budget should be balanced in fiscal years 1982 and 1983. If these conditions are met, it is the intention of the Congress that the tax-writing committees will report legislation providing significant tax reductions for individuals to the extent that these tax reductions are justified in the light of prevailing and expected economic conditions.

## **TITLE I—INDIVIDUAL INCOME TAX PROVISIONS**

### **A. INDIVIDUAL TAX REDUCTIONS AND EXTENSIONS**

#### **1. Widening of Tax Brackets, Rate Cuts, Increase in Zero Bracket Amount, and Fiscal Year Taxpayers (secs. 101 and 106 of the Act and secs. 1, 21, 63, and 1302 of the Code)**

##### ***Prior law***

Under prior law, individual income tax rates began at 14 percent on taxable income in excess of \$3,200 on a joint return and \$2,200 on a single return. There was not tax on the first tax bracket, referred to as the "zero bracket amount" (formerly the standard deduction). There was also a floor under itemized deductions equal to the zero bracket amount requiring taxpayers who itemized deductions to deduct only expenses in excess of that amount. Thus, a taxpayer receives full benefit from itemized deductions because the sum of the excess itemized deductions and the zero bracket amount equals the total amount of the itemized deductions.

Individual tax rates ranged up to 70 percent on taxable income in excess of \$203,200 for joint returns (\$102,200 for single returns). Table 3 shows the tax brackets and rates for joint returns under prior law and under the Act. Under prior law, there were 25 tax brackets.

Prior law also provided different rate schedules for single taxpayers, heads-of-households, married couple filing separately, and estates and trusts.

##### ***Reasons for change***

There will be two significant tax increases in 1979 over 1978. First, social security taxes will go up as a result of legislation enacted in 1977. Second, inflation will cause an automatic tax income increase. Rapid inflation has resulted in an increase in money incomes substantially in excess of the increase in real incomes. Because the income tax brackets are in terms of money income, inflationary increases in income move taxpayers into higher income tax rate brackets, reducing the amount of real income taxed in the lower tax brackets and increasing the portion of the real income owed as income taxes. The Congress believed that there should be individual income tax reductions to offset most of these two tax increases.

The Congress believed that tax reductions should be focused on those income groups that had not benefited a great deal from previous tax cuts and that were particularly hard hit by the recent inflation-induced and social security tax increases, namely, the middle- and upper-middle-income groups. Tax rate changes are a way to benefit these groups.

In the past, Congress has used the standard deduction (the minimum standard deduction) and the personal exemption to establish a tax-free income level approximating the poverty income level. This

policy began with the Revenue Act of 1964. The Congress believed that a tax-free income level for married persons somewhat higher than the poverty level is needed in 1979 to offset recent increases in food and other consumer prices.

The extent to which the zero bracket amount and the personal exemption determine a tax-free income level and the extent to which the tax-free level compares with projected poverty levels are shown for various taxpayers in table 1. For example, under prior law, the tax-free income level for a married couple was \$5,200. This amount is the sum of the \$3,200 zero bracket amount plus two \$750 personal exemptions plus two \$35 general credits (which is equivalent to two \$250 personal exemptions at the 14-percent income tax rate). With the increase in the zero bracket amount to \$3,400, the tax-free income level will be \$5,400 in 1979. This amount is the sum of the \$3,400 zero bracket amount and the two \$1,000 personal exemptions. (The \$35 general tax credit expired at the end of 1978.) This compares with the projected poverty income levels of \$4,621 in 1979 and \$5,291 in 1981 for a married couple without dependents.

TABLE 1.—TAX-FREE INCOME LEVELS UNDER PRIOR LAW AND THE ACT COMPARED TO PROJECTED POVERTY LEVELS

	Tax-free levels		Projected poverty levels <sup>1</sup>	
	1978 law	H.R. 13511 for 1979 and thereafter	1979	1981
Single person-----	\$3, 200	\$3, 300	\$3, 597	\$4, 118
Couple without de-				
pendents-----	5, 200	5, 400	4, 621	5, 291
Family of 4 <sup>2</sup> -----	7, 200	7, 400	7, 241	8, 290

<sup>1</sup> Applicable to nonfarm families. Projections based on estimated 1977 levels and assumed increase in the consumer price index of 7.7 percent in 1978, 8.6 percent in 1979 and 7 percent 1980 and 1981.

<sup>2</sup> Without regard to the earned income credit.

### *Explanation of provisions*

The Act provides new tax rate schedules in place of each of the tax rate schedules of prior law. The prior law rate schedule and the new one provided by the Act for married couples filing joint returns are shown in table 3 below.

#### *Increase in zero bracket amount*

The first change from present law is the increase in the zero bracket amount in the joint return schedule from \$3,200 to \$3,400. The increase is from \$2,200 to \$2,300 for single persons and heads-of-households, or one-half as much as for married couples, to avoid increasing the marriage tax penalty. For married persons filing separate returns, the increase is from \$1,600 to \$1,700.

Because the zero bracket amount, in effect, builds the old standard deduction into the tax rate schedule, it is necessary to permit itemizers to claim only those itemized deductions in excess of that amount if they are to be able to use the same tax rate schedule as nonitemizers. Otherwise, they would, in effect, get their itemized deductions *plus* the standard deduction amount. Thus, the Act also increases the present floor under itemized deductions by \$200 for joint returns, and \$100 for single, head of household, and separate returns.

The increase in the zero bracket amount will cause 1.3 million returns to shift from itemizing deductions.

The benefits from the increase in the zero bracket amount are concentrated in the lower income ranges. Table 2 shows that more than 29 percent of the tax reduction from the increase in the zero bracket amount goes to returns with incomes under \$10,000 and 73.2 percent to those with incomes below \$20,000.

**TABLE 2.—TAX REDUCTION FROM INCREASED ZERO BRACKET AMOUNT, 1978 INCOME LEVELS**

Expanded income class <sup>1</sup>	Tax decrease			Returns with decrease	
	Amount (millions)	Percent of tax <sup>2</sup>	Percentage distribution	Returns (thousands)	Percent of taxable returns
Below \$5,000-----	\$67	11. 6	5. 2	4, 563	99. 8
\$5-10,000-----	311	3. 6	24. 1	14, 645	92. 8
\$10-15,000-----	301	1. 8	23. 3	10, 053	72. 8
\$15-20,000-----	266	1. 1	20. 6	6, 608	57. 1
\$20-30,000-----	260	. 6	20. 1	5, 060	39. 1
\$30-50,000-----	72	. 2	5. 6	1, 023	17. 5
\$50-100,000-----	12	( <sup>3</sup> )	. 9	131	9. 2
\$100-200,000-----	2	( <sup>3</sup> )	. 2	14	4. 7
\$200,000 and over-----	( <sup>3</sup> )	( <sup>3</sup> )	( <sup>3</sup> )	2	2. 6
Total-----	1, 291	. 7	100. 0	42, 099	63. 5

<sup>1</sup> Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

<sup>2</sup> As a percent of positive liability before offset for the refundable portion of the earned income credit.

<sup>3</sup> Less than \$500,000 or less than .05 percent.

NOTE.—Details may not add to totals because of rounding.

The Act includes a technical amendment to the income averaging provisions (sec. 1302) relating to the addition of the zero bracket amount to base period income for years before the adoption of the zero bracket system (i.e., pre-1977). The Act specifies that the zero bracket amount to be added to base period taxable income is not to be the new, higher zero bracket amount but is to remain at the prior level (i.e., \$3,200 for joint returns, \$2,200 for single individuals and single heads of household and \$1,600 for married individuals filing separately).

*Widening of tax brackets*

A new tax rate schedule is provided with only 15 brackets for joint returns and 16 for single taxpayers, a reduction from the 25 brackets of prior law. Consequently, the size of the remaining brackets is increased, particularly in the upper brackets, as shown in table 3. In addition, four tax rates are reduced by one or two points as indicated by an asterisk on that table. In the upper income brackets, some rates are decreased and some are increased, but direct comparison to prior law is difficult because of the change in size of the taxable income brackets. (The new individual income tax rate schedules under the Act for joint returns, heads of households, unmarried individuals, married individuals filing separate returns, and for estates and trusts are shown in the Appendix.)

TABLE 3.—TAX RATE SCHEDULE UNDER PRIOR LAW AND THE REVENUE  
ACT OF 1978 FOR MARRIED COUPLES FILING JOINTLY <sup>1</sup>

*Prior Law*

<b>"If taxable income is:</b>	<b>The tax is:</b>
Not over \$3,200-----	No tax.
Over \$3,200 but not over \$4,200-----	14% of the excess over \$3,200.
Over \$4,200 but not over \$5,200-----	\$140, plus 15% of excess over \$4,200.
Over \$5,200 but not over \$6,200-----	\$290, plus 16% of excess over \$5,200.
Over \$6,200 but not over \$7,200-----	\$450, plus 17% of excess over \$6,200.
Over \$7,200 but not over \$11,200-----	\$620, plus 19% of excess over \$7,200.
Over \$11,200 but not over \$15,200---	\$1,380, plus 22% of excess over \$11,200.
Over \$15,200 but not over \$19,200----	\$2,260, plus 25% of excess over \$15,200.
Over \$19,200 but not over \$23,200----	\$3,260, plus 28% of excess over \$19,200.
Over \$23,200 but not over \$27,200----	\$4,380, plus 32% of excess over \$23,200.
Over \$27,200 but not over \$31,200----	\$5,660, plus 36% of excess over \$27,200.
Over \$31,200 but not over \$35,200----	\$7,100, plus 39% of excess over \$31,200.
Over \$35,200 but not over \$39,200----	\$8,660, plus 42% of excess over \$35,200.
Over \$39,200 but not over \$43,200----	\$10,340, plus 45% of excess over \$39,200.
Over \$43,200 but not over \$47,200----	\$12,140, plus 48% of excess over \$43,200.
Over \$47,200 but not over \$55,200----	\$14,060, plus 50% of excess over \$47,200.
Over \$55,200 but not over \$67,200----	\$18,060, plus 53% of excess over \$55,200.
Over \$67,200 but not over \$79,200----	\$24,420, plus 55% of excess over \$67,200.
Over \$79,200 but not over \$91,200----	\$31,020, plus 58% of excess over \$79,200.
Over \$91,200 but not over \$103,200----	\$37,980, plus 60% of excess over \$91,200.
Over \$103,200 but not over \$123,200----	\$45,180, plus 62% of excess over \$103,200.
Over \$123,200 but not over \$143,200----	\$57,580, plus 64% of excess over \$123,200.
Over \$143,200 but not over \$163,200----	\$70,380, plus 66% of excess over \$143,200.
Over \$163,200 but not over \$183,200----	\$83,580, plus 68% of excess over \$163,200.
Over \$183,200 but not over \$203,200----	\$97,180, plus 69% of excess over \$183,200.
Over \$203,200-----	\$110,980 plus 70% of excess over \$203,200.

*Revenue Act of 1978*

<b>If the taxable income is:</b>	<b>The tax is:</b>
Not over \$3,400-----	No Tax.
Over \$3,400 but not over \$5,500-----	14% of excess over \$3,400.
Over \$5,500 but not over \$7,600-----	\$294, plus 16% of excess over \$5,500.*
Over \$7,600 but not over \$11,900-----	\$630, plus 18% of excess over \$7,600.*
Over \$11,900 but not over \$16,000----	\$1,404, plus 21% of excess over \$11,900*
Over \$16,000 but not over \$20,200----	\$2,265, plus 24% of excess over \$16,000*
Over \$20,200 but not over \$24,600----	\$3,273, plus 28% of excess over \$20,200.
Over \$24,600 but not over \$29,900----	\$4,505, plus 32% of excess over \$24,600.
Over \$29,900 but not over \$35,200----	\$6,201, plus 37% of excess over \$29,900.
Over \$35,200 but not over \$45,800----	\$8,162, plus 43% of excess over \$35,200.
Over \$45,800 but not over \$60,000----	\$12,720, plus 49% of excess over \$45,800.
Over \$60,000 but not over \$85,600----	\$19,678, plus 54% of excess over \$60,000.
Over \$85,600 but not over \$109,400----	\$33,502, plus 59% of excess over \$85,600.
Over \$109,400 but not over \$162,400----	\$47,544, plus 64% of excess over \$109,400.
Over \$162,400 but not over \$215,400----	\$81,464, plus 68% of excess over \$162,400.
Over \$215,400-----	\$117,504, plus 70% of excess over \$215,400.

<sup>1</sup> And surviving spouses.

\*Reduction from prior rates.



Table 4 below shows the effect of increasing the zero bracket amount (which was shown separately in table 2 above) plus the reduction from widening the tax brackets and reducing tax rates. The effect of widening brackets and cutting tax rates by itself can be obtained by subtracting the tax reductions in table 2 from these reductions. This shows that the benefits of the bracket widening and rate reductions are concentrated in the income ranges of \$10,000 to \$50,000, which receive 79 percent of the total tax reduction of 9.3 billion.

TABLE 4.—TAX REDUCTION FROM WIDENING TAX BRACKETS, RATE CUTS, AND INCREASED ZERO BRACKET AMOUNT, 1978 INCOME LEVELS

Expanded income class <sup>1</sup>	Tax decrease		
	Amount (millions)	Percent of tax <sup>2</sup>	Percentage distribution
Below \$5,000-----	\$88	15. 2	0. 8
\$5,000 to \$10,000-----	886	10. 4	8. 4
\$10,000 to \$15,000-----	1, 597	9. 4	15. 2
\$15,000 to \$20,000-----	1, 839	7. 6	17. 5
\$20,000 to \$30,000-----	2, 850	6. 4	27. 0
\$30,000 to \$50,000-----	2, 010	5. 1	19. 1
\$50,000 to \$100,000-----	906	3. 8	8. 6
\$100,000 to \$200,000-----	272	2. 1	2. 6
\$200,000 and over-----	93	. 7	. 9
<b>Total</b> -----	<b>10, 541</b>	<b>5. 7</b>	<b>100. 0</b>

<sup>1</sup> Expanded income equals adjusted gross income plus tax preferences less investment interest to the extent of investment income.

<sup>2</sup> As a percent of positive liability before offset for the refundable portion of the earned income credit.

NOTE.—Details may not add to totals because of rounding.

### *Effective date*

The change in the tax rate schedule, including the higher zero bracket amount, is effective for taxable years beginning after December 31, 1978.

The Act specifically applies the rules for rate changes of fiscal year taxpayers (sec. 21 of the Code) to allow these taxpayers the benefits of the rate cuts and the increase in the zero bracket amount (as well as the increase in the personal exemption) for that part of their fiscal year which falls in 1979. In addition, the expiration of the general tax credit is treated as a change in the rate of tax. Under this provision, fiscal year taxpayers are to compute their tax liability for their full year both under 1978 law and 1979 law with respect only to the provisions listed. The difference in these two amounts is then to be prorated over the fiscal year, and the tax reduction is allowed to the extent of the amount of the fiscal year falling in 1979.

The section 21 proration rule for fiscal year taxpayers (sec. 106 of the Act) is made available only for the changes listed above in the case of individuals (those changes made by sec. 101 and 102 of the Act, and

the expiration of the general tax credit) and for the corporate rate changes made by section 301 of the Act. Any gain in equity that might result from making the section 21 rule broader is outweighed by the additional complexity that would be created for forms, instructions, and taxpayers.

***Revenue effect***

The changes in the tax rate schedules, including the zero bracket amounts, are estimated to reduce budget receipts by \$7,317 million in fiscal year 1979, \$13,057 million in fiscal year 1980, and \$21,742 million in fiscal year 1983.

## **2. Increase in the Personal Exemption (sec. 102 of the Act and secs. 151 and 6013(b) (3) of the Code)**

### ***Prior law***

Since 1972, the amount of the personal exemption has been \$750 for the taxpayer, his or her spouse, and each dependent whose gross income was less than \$750 (unless the dependent was a child of the taxpayer who was under age 19 or a student). Prior law also provided a general tax credit through 1978, which was the larger of \$35 per exemption or 2 percent of the first \$9,000 of taxable income (in excess of the zero bracket amount), with a maximum credit of \$180.

Under both prior and present law, an additional personal exemption is provided for a taxpayer who is blind or age 65 or over.

### ***Reasons for change***

The personal exemption was last increased by the Tax Reform Act of 1969, from \$600 (its level since 1948) to \$750. The \$750 exemption became effective in 1972. Inflation since then has eroded the real value of the \$750 exemption and increased the difference between \$750 and the cost of supporting a dependent. Consumer prices have in fact increased 60 percent since 1972. This erosion in the value of the exemption has been particularly severe for middle- and upper-middle income taxpayers, especially those with large families.

The Congress concluded that an appropriate adjustment in the tax structure (in conjunction with the increase in the earned income credit, the increase in the zero bracket amount, and the tax bracket and rate changes discussed above) was to increase the personal exemption from \$750 to \$1,000. This is intended as a replacement for the temporary general tax credit, which was permitted to expire at the end of 1978. This change (along with the tax rate and bracket changes) was designed to focus relief primarily on taxpayers who have been moved rapidly up the tax rate schedule due to inflation, particularly those with larger families where the increase in the cost of living has had the most severe impact.

The \$35 per exemption credit provided by the general tax credit was the equivalent of an additional \$250 worth of personal exemption at the bottom tax rate ( $14\% \times \$250 = \$35$ ). Therefore, the substitution of the \$250 exemption increase for the credit will not increase the taxes of lower-income taxpayers and will result in a tax decrease for those whose income is taxed at a rate higher than 14 percent and who elected the \$35 credit rather than the 2-percent alternative credit. It does not affect the tax-free income level.

While no taxpayers will experience a tax increase as a result of the replacement of the \$35 per exemption credit by a \$250 exemption increase, some taxpayers who elected the 2-percent-of-taxable-income alternative credit will have a tax increase which will not be offset by the rate changes in the Act. These are almost entirely single persons or

married couples with no dependents who itemize their deductions. (For nonitemizers, the increase in the zero bracket amount prevents virtually any tax increases.) The overall effect of these changes is that only 109,000 taxpayers or about one-tenth of one percent of the total, will experience a tax increase from the combination of *these three* provisions.

The Congress was also concerned about two other aspects of the general tax credit, which contributed to the conclusion that a \$250 increase in the personal exemption would be preferable. First, the general tax credit was an *additional* provision. Although most taxpayers did not have to compute it because it had been built into the tax tables, it was a source of complexity. Some taxpayers who cannot use the tax tables (generally because their income is in excess of \$20,000 for single persons and \$40,000 for joint returns) had to compute the credit.

The existence of the general tax credit for even a few taxpayers required 7 lines on the tax computation schedule (schedule TC) out of the 11 lines used for the tax computation. It also required an explanation in both the regulations and instructions.

Second, the 2-percent alternate credit increased the marriage tax penalty that often results when two single persons with fairly equal earnings marry each other. Because single persons and joint returns were each limited to a maximum credit of \$180, a total of \$360 for the two single taxpayers, they lost as much as \$180 of general tax credit when they married. The desire to reduce the marriage penalty resulting from the general tax credit is what necessitated many of the tax increases for single persons.

### ***Explanation of provision***

The Act provides a permanent increase in the personal exemption from \$750 to \$1,000 and also increases the gross income limit for a dependent from \$750 to \$1,000. (The additional personal exemption for those age 65 and over or blind is continued and also increased to \$1,000.) The general tax credit was allowed to expire at the end of 1978.

Substitution of the \$1,000 personal exemption for the general tax credit changes tax liabilities of taxpayers with different incomes by different amounts. The effect of the change by income class is shown in Table 5 below. The tax increases shown result from the loss of the 2 percent of taxable income credit. These increases generally are offset by the rate cuts.

TABLE 5.—TAX CHANGE FROM SUBSTITUTING A \$1,000 PERSONAL EXEMPTION FOR THE GENERAL TAX CREDIT, 1978 INCOME LEVELS

Expanded income class <sup>1</sup>	Tax decrease	
	Amount (millions)	Percent of tax
Below \$5,000.....	\$15	10. 9
\$5,000 to \$10,000.....	-184	-2. 2
\$10,000 to \$15,000.....	-394	-2. 3
\$15,000 to \$20,000.....	-94	- . 4
\$20,000 to \$30,000.....	571	1. 3
\$30,000 to \$50,000.....	765	1. 9
\$50,000 to \$100,000.....	382	1. 6
\$100,000 to \$200,000.....	95	. 7
\$200,000 and over.....	33	. 2
<b>Total</b> .....	<b>1, 189</b>	<b>. 6</b>

<sup>1</sup> Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

NOTE. A negative number indicates a tax increase.

### *Effective date*

The increase in the personal exemption is effective for taxable years beginning after December 31, 1978. The general tax credit will no longer apply for taxable years ending after December 31, 1978.

As discussed above in relation to the rate cuts, the Act applies the rules for rate changes of fiscal year taxpayers (sec. 21 of the Code) to allow these taxpayers the benefits of the personal exemption (as well as the rate cuts and increase in the zero bracket amount) for that part of their fiscal year which falls in 1979.

### *Revenue effect*

The increase in the personal exemption, net of the expiration of the general tax credit, is estimated to reduce budget receipts by \$899 million in fiscal year 1979, \$1,362 million in 1980, and \$1,679 million in fiscal year 1983.

### **3. Changes in Filing Requirements and Withholding Changes (secs. 101 and 102 of the Act and secs. 6012(a) and 3402(b) and (m) of the Code)**

#### ***Prior law***

Under prior law, a tax return had to be filed by a single person and a head of household if his or her income was \$2,950 or more a year and by a married couple filing a joint return if their income was \$4,700 or more. There were different filing requirements for surviving spouses, for married couples, and where the taxpayer was age 65 or over.

These amounts represented the zero bracket amount of \$2,200 for single persons and heads of household and \$3,200 for joint returns plus \$750 for each personal exemption. (The filing requirements did not reflect the temporary general tax credit.) For each additional exemption resulting from the taxpayer or his spouse being age 65 or over, these amounts were increased by \$750. Thus, a single person age 65 or over did not need to file until his or her income was \$3,700 or more; a married couple, both under age 65, \$4,700 or more; a married couple with only one spouse age 65 or over, \$5,450 or more; and a married couple with both spouses age 65 or over, \$6,200 or more.

The withholding schedules reflected the prior law tax rates, the zero bracket amount, the amount of the personal exemption, and the general tax credit (one and 3 \$35 tax credits in single and married withholding rate schedules, respectively).

#### ***Reasons for change***

When the zero bracket amount and the amount of the personal exemption are permanently increased, the income levels for filing a tax return should be conformed to the new tax-free income levels. Also, any such increases should be reflected in withholding changes as should the tax rate reductions provided by the Act.

#### ***Explanation of provision***

The income levels at which a tax return must be filed are increased to reflect the increase in the zero bracket amount from \$2,200 to \$2,300 for single persons and from \$3,200 to \$3,400 for joint returns and the increase in the personal exemption from \$750 to \$1,000. Consequently, the new filing level under the Act is \$3,300 for a single person, \$5,400 for a married couple both under age 65, \$6,400 if only one spouse is age 65 or over, and \$7,400 if both spouses are age 65 or over.

The withholding rates and tables are to be changed by the Secretary of the Treasury to reflect the increase in the zero bracket amount and the personal exemption and the tax rate changes. The percentage method withholding allowances are changed in the Act to reflect the increase in the personal exemption (sec. 3402(b) of the Code). A conforming change is made in the provision under which additional withholding exemptions can be claimed for itemized deductions in excess of

the zero bracket amount to reflect the increase in that amount and the amount of the personal exemption.<sup>1</sup>

Another group of taxpayers, single persons with earnings in excess of \$33,167 and married taxpayers with earnings above \$75,000 will have withholding increases because the top withholding rate was increased from 36 percent to 39 percent for single persons and from 36 to 37 percent for married couples. (These income levels assume that the taxpayers claim all the withholding exemptions to which they are entitled. If they claim fewer, the increase will occur at lower levels.) Most of these people have underwithholding, so this change will reduce their estimated tax or final payment.

The Treasury also changed the daily payroll period withholding table. The daily or miscellaneous withholding rate schedule and the associated withholding wage bracket tables were previously constructed on the assumption that the taxpayer works in a situation in which there are 365 separate payroll periods each year and that the taxpayer has earnings in every one of those 365 pay periods. As a result, the vast majority of earners who are paid on the basis of a daily payroll period but who do not work every day of the year were substantially overwithheld.

The new daily tables are based on withholding allowances which assume 365 pay periods per year, as specified by the Act, and withholding allowances based on 260 pay periods a year, or 5 days per week.

### ***Effective date***

The changes in the filing requirements are effective for taxable years beginning after December 31, 1978, and the withholding changes apply to remuneration paid after December 31, 1978.

### ***Revenue effect***

This provision has no direct revenue effect, as the revenue changes are attributed to the substantive changes in the tax law, not the filing requirement or withholding changes.

<sup>1</sup> Under the withholding rate schedules adopted by the Treasury Department pursuant to the Act, some taxpayers received a withholding increase beginning in January 1979. This occurred because the \$35 per-exemption credit was built into the withholding rate schedules as if it were an increase in the zero bracket amount (one for single returns and 3 for joint returns). This credit expired at the end of 1978. Lower- and middle-income single taxpayers who claim no exemptions for withholding, and married couples who claim zero or few withholding exemptions, experienced an increase in withholding tax because the withholding increase from repeal of the general tax credit outweighs the reduction from the increase in the personal exemption from \$750 to \$1,000 and the rate cuts.

This withholding increase was unavoidable for taxpayers who claim zero or few withholding exemptions without significantly changing the withholding system because of the way the general tax credit had been built into the withholding system as if it were an increase in the zero bracket amount.

These increases are relatively small and taxpayers may avoid them by claiming one or more additional withholding exemptions. They should note that one exemption will reduce withholding by \$150 to \$390 per year (generally about \$250) and this could cause underwithholding. Moreover, taxpayers who claim additional withholding allowances because of large itemized deductions or credits should review their number of withholding allowances on the revised form W-4, and perhaps submit a new form claiming fewer withholding allowances. Otherwise they may be unexpectedly underwithheld for 1979 since the value of these additional exemptions has increased from \$750 to \$1,000 for withholding purposes but there has been no corresponding reduction in tax liability.

#### **4. Earned Income Credit (secs. 103, 104, and 105 of the Act and secs. 43 and 3507 of the Code)**

##### ***Prior law***

Under prior law, an eligible individual was allowed a credit against tax equal to 10 percent of the first \$4,000 of earned income (for a maximum credit of \$400). The amount of the credit was phased out as the adjusted gross income (or earned income, if greater) of an individual increased from \$4,000 to \$8,000. Under this phase-out, one dollar of credit was lost for each ten dollars of income in excess of \$4,000, regardless of whether the individual had at least \$4,000 of earned income. Because the credit was refundable, it could exceed an individual's income tax liability for the year. Thus, individuals with low incomes, on which little or no tax was due, could receive cash payments equal to the amount of the credit (reduced by any tax due).

Earned income eligible for the credit included all wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment. Earned income was eligible for the credit, however, only if it was includible in the gross income of the taxpayer during the taxable year in which the credit was claimed. Amounts received as pension or annuity benefits could not be taken into account for purposes of the credit, and the credit was not available with respect to income of non-resident alien individuals that was not connected with a U.S. trade or business.

An individual was eligible for the earned income tax credit only if that individual maintained a household in the United States for himself or herself and for one or more children who were under the age of 19, were students, or were disabled dependents. Further, in order to claim the credit, the individual must not have been entitled to exclude any amounts from gross income under section 911 (relating to earned income from sources outside the United States) or section 931 (relating to income from sources within the possessions of the United States).

For purposes of the maintenance of household requirement, an individual was considered to be maintaining a household if he or she (or, if married, the individual and his or her spouse) provided over half the cost of maintaining the household (including costs attributable to children who are dependents). Maintenance expenses of a household normally included items such as property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises.

Prior law required that the earned income credit not be taken into account as income for purposes of determining eligibility for, or the amount of, benefits or assistance under any Federal program or State or local program financed in whole or in part with Federal funds.

Under prior law, the earned income credit was scheduled to expire at the end of 1978.



### ***Reasons for change***

The Congress believed that the earned income credit is an effective way to provide work incentives and relief from income and Social Security taxes to low-income families who might otherwise need large welfare payments. The credit was enacted by the Congress in 1975 for two years and was subsequently extended for an additional year through 1978. Since the credit has proven to be an effective way of providing tax relief for low-income families, while at the same time providing work incentives for these individuals, the Congress has decided to make the credit permanent.

The Congress also considered the amount of the credit, which had not changed since 1975. Since the purpose of the credit has been to provide a work incentive, the Congress believed it to be appropriate to increase the amount of the credit to take into account the increase in the cost of living during the past several years as well as current minimum wage levels. As a result, the Act increases the credit so that it is equal to 10 percent of the first \$5,000 of earned income (a maximum credit of \$500), which is phased out between \$6,000 and \$10,000 of adjusted gross income (or, if higher, earned income).

Congress also examined the administrative aspects of the earned income credit with a view to making it simpler and more effective. The major concern that the Congress focused on was the time at which eligible individuals can receive the benefit of the credit. Under prior law, an individual did not receive the benefit of the credit until the end of the year when he or she filed a tax return. The Congress believed that the credit can work more effectively if an individual is able to receive it during the year while he or she is working. This provides the tax relief at a time when the individual is more likely to need it. Therefore, the Act provides for advance payments of the credit to be made by employers to eligible employees. The Congress believes that this new procedure will increase the work incentive provided by the credit.

The Act also contains modifications which make it easier for the eligible individuals to determine eligibility for, and the amount of, the credit, and for the Internal Revenue Service to be able to determine eligibility and amount of the credit from other data filed with the tax return.

Finally, the Act repeals the provision that prohibits the credit from being taken into account for purposes of determining eligibility for, or amount of, Federal benefits, or for benefits under a State or local needs-tested program financed in whole or in part from Federal funds. The Congress believed that in order for the earned income credit to be an effective incentive to work and a disincentive for being on welfare, the credit should be treated as earned income for purposes of the aid to families with dependent children and Supplemental Security Income programs.

### ***Explanation of provisions***

#### ***Credit made permanent and increase in the credit***

The Act makes the earned income credit permanent, and increases the amount of the credit to 10 percent of the first \$5,000 of earned income; this results in a maximum credit of \$500, beginning in 1979.

The Act raises the income range over which the credit phases out from between \$4,000 and \$8,000 of income to between \$6,000 and \$10,000 of income.

*Simplification of the credit*

*Revised income limitation.*—The Act revises the income limitation on the credit, both to take account of the increase in the amount of the credit and to allow the credit to be determined directly from tables. Under prior law, the actual amount of the allowable credit was reduced by one dollar for each \$10 by which adjusted gross income (or, if greater, earned income) exceeded \$4,000. Under the Act, however, the maximum allowable credit will be phased down as income rises above \$6,000. Specifically, the allowable earned income credit for any taxable year will be limited to the excess of \$500 over 12.5 percent of the excess of adjusted gross income (or, if greater, earned income) over \$6,000. Thus, the credit is zero for families with incomes over \$10,000.

For example, a taxpayer with \$4,000 of earnings and \$8,000 of adjusted gross income would have an earned income credit of \$250, which is the lower of (a) 10 percent of \$4,000, or (b) \$500 minus 12.5 percent of \$2,000 (\$8,000–\$6,000).

*Credit determined by use of tables.*—The Act provides that the amount of the credit allowed is to be determined under tables prescribed by the Secretary. The Congress intends that the taxpayer determine the credit amount by selecting the lower of two numbers, each of which is found in a separate table. The first table will use income brackets not greater than \$50 each between zero and \$10,000 and will show the credit allowed under the assumption that earned income equals or exceeds adjusted gross income. The second table will reflect the credit allowable if earned income and adjusted gross income are at least \$6,000, and if adjusted gross income is greater than, or equal to, earned income. The individual would apply his earned income to the first table to find a tentative credit amount and would apply his adjusted gross income (if greater than \$6,000) to the second table to find a second tentative credit amount, and the actual credit allowed would be the lower of the two tentative credits.

*Income eligible for the credit.*—The Act repeals the provision that earned income eligible for the credit does not include any items which are excluded from adjusted gross income. Under prior law, excludable items such as excluded disability income and the rental value of a parsonage had to be subtracted in determining earned income eligible for the credit. Under the Act, these subtractions will not be necessary.

*Individuals eligible for the credit.*—The Act changes eligibility requirements for the credit so that individuals who are eligible for the credit can be identified from entries on the individual income tax return (Form 1040) after a slight modification in the form to identify heads of household who maintain a household for a child. Those changes will allow the Service to give the credit to taxpayers who are eligible for the credit but who neglect to claim it. Any individual who is considered to be married and who is entitled to a dependency exemption for a child, any surviving spouse, and any head of a household who maintains a household for a child generally will be eligible for the earned income credit. However, for a married individual, the dependent child must live in the individual's principal place

of abode, which must be in the United States. For this purpose, the Internal Revenue Service may use an individual's mailing address to determine whether the individual's principal place of abode is in the United States. The household which a surviving spouse or head of household must maintain in order to qualify for either status also must be in the United States if the individual is to qualify for the credit. As under current law, individuals entitled to exclude any foreign source income under sections 911 or 931 will be ineligible for the credit.

Compared with prior law, the Act extends the credit to two small groups of taxpayers: (1) married couples and surviving spouses now denied the credit because the only dependent child living with them is over 18 and neither disabled nor a student, and (2) heads of household who qualify for that status on the basis of either a dependent or nondependent child in the same category. The Act denies the credit to two other small groups: (1) married couples who qualify for the credit only because they have living with them a child who does not qualify for a dependency exemption and who is under 19 or a student, and (2) heads of household and single individuals who now qualify for the credit only because they have living with them a married, nondependent child who is either under 19 or a student.

#### *Advance payment of the credit*

The Act provides that an eligible individual may elect to receive advance payment of the earned income credit from his employer. Any individual who receives advance payments during a calendar year would be liable for the excess of such payments over the actual amount of the credit, which cannot be determined until the end of the year. Conversely, individuals whose advance payments for a year are less than the actual amount will be credited with the excess of the actual credit over the advance payments.<sup>1</sup>

An employee who believes that he is eligible for the credit may claim advance payments by providing the employer with a certificate on which the employee certifies that he expects to be eligible for the credit and that he does not have a certificate in effect with another employer, and on which the employee states whether his spouse has a certificate in effect.

The Secretary will prescribe by regulation the form and contents of the certificate.<sup>2</sup> It should contain, however, a complete description of the conditions governing eligibility for the credit.

Any certificate remains in effect for the remainder of the calendar year unless revoked or unless a new certificate takes effect. If the em-

<sup>1</sup> Technically the total amount of advance payments is to be treated as an additional amount of tax owed by the employee on his tax return, but the actual earned income credit is allowed in full against that tax liability. Thus, the taxpayer will have a net increase or decrease in tax, depending on whether his advance payments are greater or less than his actual credit. Any individual who receives advance payments will be required to file an income tax return.

<sup>2</sup> The certificate of an employee making his first application to the employer will take effect at the beginning of the first payroll period, or at the first payment of wages on or after the date on which the certificate is furnished. For subsequent certificates, however, the employer may delay putting the certificate into effect for at least 30 days, but no later than the next status determination date (January 1, May 1, July 1, or October 1) following the expiration of the 30-day period.

ployee's spouse puts into effect or revokes a certificate with his employer, or the employee becomes ineligible for the earned income credit, the employee must revoke the certificate or furnish a new one.

For any employee with a certificate in effect, the employer is required to add the advance payment to the employee's paycheck. The advance payment would be reflected in the employee's W-2 form as a separate item; it would not be treated as a reduction of withholding. The amount of advance payment is to be determined from tables which take into account the amount of wages paid in the pay period and whether an employee's spouse is claiming advance payments. If the employee certifies that his spouse is not claiming advance payments, then the employer would use a table which would treat the earned income credit as less than or equal to a credit of 10 percent of the first \$5,000 of earned income, phasing out (at a 12.5 percent rate) between \$6,000 and \$10,000 of income. If the employee certifies that his spouse is claiming advance payments, then the employer would instead use a table which would treat the earned income credit as less than or equal to a credit of 10 percent of the first \$2,500 of earned income, phasing out between \$3,000 and \$5,000 of income.<sup>3</sup> The use of a separate table for those employees whose spouses also are claiming payment is intended to substantially reduce the probability of advance payments for such individuals exceeding the amount to which they are ultimately entitled. In other cases where the employee believes that the advance payments may be too large because they do not take into account other income (such as unearned income or income from a second job), the employee may offset a portion of the advance payment by increasing his ordinary income tax withholding. This can be accomplished simply by reducing the number of withholding allowances he claims on his withholding certificate. Furthermore, the Treasury is given the discretion to make advance payments of less than the full amount of the credit so that it can design the tables in such a way as to minimize the number of individuals whose advance payments are more than the actual credit to which they are ultimately entitled.

The aggregate amount of advance payments which the employer makes to employees in any pay period will be treated as payments, for that pay period, of withholding taxes on all employees, the employee share of FICA taxes, and the employer share of FICA taxes. Thus, the amount of these payments which the employer will make to the Federal government will be reduced by the amount of advance payments.<sup>4</sup> If the aggregate amount of advance payments exceeds the total of these payroll taxes (which could occur for employers exempt from withholding for State or local governments not subject to

<sup>3</sup> For example, suppose that an individual works part-time with an annual wage of \$4,800 and that the employer makes monthly wage payments of \$400. If the individual's spouse is not claiming advance payments, then the employer would compute the advance payment from a table designed for this category of employee; the amount would be less than or equal to \$40 (i.e., 10 percent of \$4,800 divided by 12, the number of pay periods in the year). If the individual's spouse is claiming advance payments, then the table for this category of employee would be less than or equal to \$2.08 (i.e., \$250 minus 12.5 percent of \$1,800 (\$4,800—\$3,000), divided by 12).

<sup>4</sup> Reduced payments of FICA taxes will not affect appropriations to the Social Security trust funds, since those appropriations are determined by FICA liabilities, not collections.

FICA taxes, for example), then the employer may either reduce the amounts of advance payments to all eligible employees by a uniform rate in order to eliminate the excess, or, under regulations prescribed by the Secretary of the Treasury, he may treat the excess as advance payment of any other tax imposed under the Code. Employers who fail to make advance payments to an employee who furnishes a certificate shall be subject to the same penalty which would be imposed by the Code if the employer refused to withhold the same amount.

#### *Treatment of credit as earned income*

The Act repeals the provision in current law requiring that the credit be disregarded for purposes of cash or in-kind Federal or Federally-aided assistance programs. The Congress intended that the credit should be treated as earned income for purposes of the Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) programs.

This treatment applies both to the actual amount of advance payments and to the excess of the actual credit for a year over the total amount of advance payments for that year. (This excess cannot actually be received until the following calendar year.) In the case where the advance payments exceed the actual credit, so that the individual must return the difference, earned income for the purpose of these programs must be reduced by the amount of the difference.

#### *Effective date*

The increase in the credit, the simplifying changes, and the requirement that employees who claim any advance payments must file tax returns apply to taxable years beginning after December 31, 1978. The advance payment provisions will be effective for remuneration paid after June 30, 1979. The provisions repealing the disregard provisions and requiring that the credit be treated as earned income will be effective on January 1, 1980.

#### *Revenue effect*

The permanent extension of the earned income credit will not affect fiscal year 1979 budget receipts or outlays; the budget cost (reduction in receipts and increase in outlays from the refundable part) will be \$1,061 million in fiscal year 1980 and \$938 million in fiscal year 1983.

The budget cost (reduction in receipts and increase in outlays from the refundable part) of the increase in and simplifying changes made in the credit will be \$82 million in fiscal year 1979, \$1,227 million in fiscal year 1980, and \$900 million in fiscal year 1983.

## **B. ITEMIZED DEDUCTIONS; UNEMPLOYMENT COMPENSATION; CREDITS**

### **1. Repeal of Deduction for State and Local Nonbusiness Gasoline and Other Motor Fuel Taxes (sec. 111 of the Act and sec. 164 (a)(5) of the Code)**

#### ***Prior law***

Under prior law, an individual who itemized deductions could deduct State and local taxes imposed on gasoline, diesel, and other motor fuels not used in business or investment activities (sec. 164(a)(5)). For example, taxes on gasoline consumed in personal use of a family car were deductible by an itemizer.

A taxpayer who purchased and used gasoline for nonbusiness purposes could obtain the deductible amount of State gasoline taxes from tables printed in the instructions for the Federal income tax return (IRS Form 1040).<sup>1</sup> The table amounts were based on mileage driven during the year, the number of cylinders in the engine, and the gasoline tax rates in each State. Two or more calculations had to be made from the tables if the tax rate in the particular State changed during the year, or if the taxpayer purchased gasoline in States having different tax rates. If an itemizer did not want to use the gasoline tax tables, or had purchased and used other motor fuels for nonbusiness purposes, he or she had to obtain and keep receipts showing the exact amounts of State and local taxes paid.

#### ***Reasons for change***

The Congress believes that State-local gasoline taxes essentially constitute charges for the use of highways, comparable to the nondeductible Federal gasoline tax. Therefore, these taxes are more like personal expenses for automobile travel (as are highway tolls or the cost of gasoline itself) than like income or other general State-local taxes. To allow deduction of the gasoline tax is inconsistent with the user-charge nature of the tax, in that deductibility serves to shift part of the cost from the highway user to the general taxpayer.

The Congress also believes that the availability of this deduction places recordkeeping burdens on those taxpayers who keep receipts for all motor fuel purchases (as is required except for State gasoline taxes) or keep records as to miles driven; and if the taxpayer fails to keep such records, the amounts claimed may be based on guesswork. In addition, the deduction (which is claimed by virtually all itemizers) presents audit difficulties for the Internal Revenue Service, since there is no ready way of gauging the correctness of the amount claimed from data on the return or from easily obtainable records, or of verifying mileage claims made by taxpayers using the gasoline tax

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<sup>1</sup> For taxpayers in Hawaii, county gasoline taxes had to be calculated from receipts and added to the table amount.

tables. Accordingly, repeal of the deduction will help achieve tax simplification for taxpayers and will reduce audit problems for the IRS. Also, the average amount of tax savings to itemizers resulting from the deduction is relatively small.

In addition, the Congress believes that, in view of the pressing national need to conserve energy and reduce oil imports, the Federal Government should not, in effect, partially subsidize nonbusiness consumption of motor fuels through a deduction for State-local taxes on such fuels. The repeal of this deduction, therefore, is an indication that the Congress is concerned with gasoline consumption.

### ***Explanation of provision***

The Act repeals the itemized deduction for State and local taxes on gasoline, diesel, and other motor fuels not used by the taxpayer in business or investment activities.

### ***Effective date***

The repeal of the deduction is effective for taxable years beginning after December 31, 1978.

### ***Revenue effect***

This provision will increase budget receipts by \$471 million in fiscal year 1979, \$1,237 million in fiscal year 1980, and \$2,029 million in fiscal year 1983.

## **2. Tax Treatment of Unemployment Compensation (sec. 112 of the Act and new secs. 85 and 6050 B of the Code)**

### ***Prior law***

Prior law did not expressly exclude from gross income amounts received under unemployment compensation programs. However, unemployment compensation paid under most government programs was exempt from taxation under a series of Internal Revenue Service rulings beginning in the 1930's.<sup>1</sup> These rulings reflected a long-standing policy on the part of the Internal Revenue Service to exempt from taxation payments made under legislatively provided social benefit programs for promotion of the general welfare. (Railroad unemployment insurance benefits specifically are exempted from taxation under the Railroad Unemployment Insurance Act itself.)

In addition to these programs, the Internal Revenue Service has held that in certain circumstances benefits received as a substitute for unemployment compensation pursuant to State unemployment disability plans are excluded from gross income as unemployment compensation.<sup>2</sup>

In contrast to its rulings on unemployment compensation benefits paid under government programs, however, the Internal Revenue Service consistently has held that unemployment compensation benefits paid under private plans are taxable to the extent that they exceed the recipient's prior contributions.<sup>3</sup>

### ***Reasons for change***

The Congress believes that a portion of unemployment compensation benefits paid under government programs should be includible in gross income because such benefits are, in substance, a substitute for taxable wages and are equivalent to unemployment benefits paid pursuant to private plans, which are includible in gross income to the

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<sup>1</sup> The relevant rulings are I.T. 3230, 1938-2 C.B. 136 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 55-652, 1955-2 C.B. 21 (unemployment compensation payments to Federal employees by State or Federal agencies); Rev. Rul. 70-280, 1970-1 C.B. 13 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 73-154, 1973-1 C.B. 40 (unemployment compensation payments made under the Emergency Unemployment Compensation Act of 1971); Rev. Rul. 76-63, 1976-1 C.B. 14 (unemployment compensation payments made under the Emergency Jobs and Unemployment Assistance Act of 1974 and the Emergency Unemployment Compensation Act of 1974); Rev. Rul. 76-144, 1976-1 C.B. 17 (payments made under the Disaster Relief Act of 1974); and Rev. Rul. 76-229, 1976-1 C.B. 19 (trade readjustment allowances paid under the Trade Act of 1974).

<sup>2</sup> Rev. Rul. 75-499, 1975-2 C.B. 43 and Rev. Rul. 75-479, 1975-2 C.B. 44. Such plans presently are in effect in New York, New Jersey, Hawaii, California, Rhode Island, and Puerto Rico.

<sup>3</sup> I.T. 1918, III-1 C.B. 121 (1924); Rev. Rul. 56-249, 1956-1 C.B. 488; Rev. Rul. 57-383, 1957-2 C.B. 44; Rev. Rul. 58-128, 1958-1 C.B. 89; Rev. Rul. 59-5, 1959-1 C.B. 12; and Rev. Rul. 71-70, 1971-1 C.B. 27.



extent that they exceed the recipient's prior contributions. The Congress also believes that the prior total exclusion of unemployment compensation benefits paid under government programs tended to create a work disincentive in that it increased the incentive to remain unemployed, the length of unemployment, and the consequent cost of maintaining unemployment coverage. Thus, for taxpayers with substantial other income during the year, the Act subjects to income tax a portion of unemployment benefits.

### ***Explanation of provision***

In general, a portion of benefits in the nature of unemployment compensation paid pursuant to government programs will be included in the recipient's gross income. The amount of unemployment compensation included in income will be limited to one-half of the excess of (1) the sum of the taxpayer's adjusted gross income, all unemployment compensation paid pursuant to government programs, and all disability income of the type eligible for exclusion from income (under sec. 105(d)) over (2) the taxpayer's "base amount."

The base amount is \$25,000 in the case of a married individual filing a joint return; zero in the case of a married individual filing a separate return, unless he or she lived apart from his or her spouse for the entire taxable year; and \$20,000 in the case of all other individuals.<sup>4</sup> The base amount is zero for married individuals filing separate returns because the Congress believes that the family should be treated as an integral unit in determining the amount which is includible under this provision. If a married taxpayer files a separate return, which includes only his or her own income and not his or her spouse's, the taxpayer should not be entitled to a higher base amount.

In determining the amount of disability income which may be excluded from adjusted gross income under section 105(d), the portion of unemployment compensation which is included in gross income under this provision is taken into account as part of the taxpayer's adjusted gross income for purposes of the phaseout of the exclusion of disability income when adjusted gross income exceeds \$15,000.

For purposes of this provision, "unemployment compensation" means any amount received under a law of the United States or of a State which is in the nature of unemployment compensation. Unemployment compensation programs are those designed to provide benefits to normally employed workers during periods of unemployment. An illustrative but not necessarily all-inclusive list of unemployment insurance programs is as follows: (1) Federal-State Regular Un-

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<sup>4</sup>The operation of these rules may be illustrated by the following example. H and W are married taxpayers. H is disabled and receives \$4,500 of disability income of a type eligible for exclusion under section 105(d). W works for part of the year and earns \$20,000, but is laid off and receives \$5,000 in unemployment compensation under a government program during the remainder of the year. H and W file a joint return. Their income including disability income and unemployment compensation is \$29,500 (the sum of \$4,500 disability income, \$20,000 salary, and \$5,000 unemployment compensation). The excess of \$29,500 over their base amount, \$25,000 is \$4,500, and one-half of the excess is \$2,250. Accordingly, \$2,250 of W's \$5,000 of unemployment compensation is included in gross income and the remaining \$2,750 is excluded.

employment Insurance Program, (2) Federal-State Extended Unemployment Insurance Program, (3) Unemployment Compensation Program for Federal Civilian Employees, (4) Unemployment Compensation Program for Ex-Servicemen; (5) Railroad Unemployment Insurance Program, (6) Trade Readjustment Assistance pursuant to the Trade Act of 1974, (7) Redwood National Park Employee Protection Program, (8) Employee Protection Program under the Airline Deregulation Act of 1978, and (9) Unemployment Compensation under the Disaster Relief Act of 1974.

The definition of unemployment compensation covered by this provision also includes disability benefits paid under Federal or State law as a substitute for unemployment benefits to individuals who are ineligible for unemployment benefits because they are disabled.<sup>5</sup> However, workmen's compensation or benefits in the nature of workmen's compensation are not unemployment compensation and will continue to be totally excludible from income under section 104(a) (1) of the Code. Benefits paid under private supplemental unemployment benefit plans will continue to be includible in gross income to the extent that they exceed the employee's prior contributions.

Under some government unemployment compensation programs, employees are required to make contributions based on their wages. If the taxpayer is not allowed a deduction for a contribution, then the benefits of such programs are not to be considered in the calculations made under this provision until an amount equal to the total nondeductible contributions has been received by the taxpayer.

Finally, the Act requires every person who makes payments of unemployment compensation aggregating \$10 or more to any individual during any calendar year to make a return, according to forms or regulations prescribed by the Secretary, setting forth the aggregate amount of such payments and the name and address of the individual to whom paid. Also, every person who is required to make such a return must furnish to each individual whose name is set forth in the return a written statement showing (1) the name and address of the person making the return, and (2) the aggregate amount of payments to the individuals as shown on the return. No statement is required to be furnished to any individual unless the aggregate amount of payments to the individual is \$10 or more.

### ***Effective date***

The provision applies to unemployment compensation paid after December 31, 1978, in taxable years ending after that date.

### ***Revenue effect***

This provision will not affect budget receipts in fiscal year 1979, and will increase receipts by \$251 million in fiscal 1980 and \$263 million in fiscal year 1983.

<sup>5</sup> See note 2, *supra*.

### **3. Political Contributions (sec. 113 of the Act and sec. 41 of the Code)**

#### ***Prior law***

Under prior law, an individual who itemized deductions could deduct political or newsletter fund contributions of up to \$100 per year (\$200 in the case of a joint return). Contributions eligible for the deduction could be made to: (1) candidates for nomination or election to Federal, State, or local office in general, primary, or special elections; (2) committees sponsoring such candidates; (3) national, State, or local committees of a national political party; and (4) newsletter funds of an official or candidate.

Alternatively, a taxpayer could elect an income tax credit equal to one-half of such political and newsletter fund contributions, but not more than \$25 (\$50 in the case of a joint return) (sec. 41). The credit could not exceed the taxpayer's income tax liability as reduced by the sum of any credits claimed for foreign taxes, for the elderly, and for investments in certain property.<sup>1</sup> An individual who did not itemize deductions could utilize the tax credit.

If an individual itemized deductions and made political contributions of \$50 or less (\$100 or less on a joint return), the credit generally would result in a greater tax benefit than the deduction, unless the contributor's marginal tax bracket was 50 percent or higher. For contributions of \$100 or more (\$200 or more on a joint return), the deduction (if the taxpayer itemizes) would result in a greater tax benefit than the credit, unless the contributor's tax bracket was less than 25 percent. To determine whether the credit or deduction would produce the greater tax benefit if a \$50-\$100 contribution was made (\$100-\$200 in the case of a joint return), taxpayers would have to calculate their tax both ways. The result depended on the amount of the contribution, other items on the return, and the taxpayer's marginal income tax bracket.

#### ***Reasons for change***

The credit for political contributions can be an effective means of encouraging individuals to participate actively in the electoral process by donating to the candidate or party of their choice. The credit, in effect, reduces the cost of an eligible contribution to the donor. In addition, it has the same value at all income levels, and is available regardless of whether the individual itemizes deductions. Moreover, since the maximum credit is small, it probably has the greatest incentive effect with respect to contributions of moderate amounts.

However, the availability of an itemized deduction for political or newsletter fund contributions, as an alternative to the credit available

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<sup>1</sup> Apart from the political contribution deduction and credit provisions, section 6096 of the Code allows a taxpayer to earmark \$1 (\$2 on a joint return) of his or her Federal income tax liability for contribution to the public financing of Presidential campaigns.

for such contributions, results in complications by requiring additional lines on the income tax return (IRS Form 1040), and additional instructions for the return. As a practical matter, the deduction-credit alternative may compel many taxpayers to calculate their tax liability both ways to determine which option would produce the greater tax benefit.

To further expand individual participation in the electoral process, through the encouragement of political contributions, and to simplify the tax system, the Congress believed that it was appropriate to increase the maximum amount of the credit for political contributions, and to repeal the alternative deduction.

### ***Explanation of provision***

The Act repeals the itemized deduction for political contributions, and increases the maximum amount of the income tax credit for political contributions from \$25 to \$50 (\$100 in the case of a joint return). In all other respects, the Act retains the limitations of present law on the credit's availability.

### ***Revenue effect***

This provision is effective for taxable years beginning after December 31, 1978.

### ***Effective date***

This provision will reduce budget receipts by \$20 million in fiscal year 1980, and \$20 million in fiscal year 1983.

#### **4. Child Care Credit for Payments to Related Individuals (sec. 121 of the Act and sec. 44 of the Code)**

##### ***Prior law***

Prior to the Tax Reform Act of 1976, an itemized deduction (subject to certain limitations) was allowed for household and dependent care expenses incurred in order to enable the taxpayer to work. The deduction was not available for amounts paid to relatives.

The 1976 Act replaced the deduction with a nonrefundable credit equal to 20 percent of household and dependent care expenses incurred to care for a dependent child under the age of 15 or for an incapacitated dependent or spouse. The maximum tax credit for one year's qualifying expenses is \$400 for one dependent and \$800 for two or more dependents (sec. 44A of the Code).

The credit was allowed for amounts paid to a relative only if (1) neither the taxpayer nor the taxpayer's spouse was entitled to treat the relative as a dependent for whom a personal exemption deduction could be claimed, and (2) the services provided by the relative constituted "employment" as that term is defined for purposes of social security taxes (sec. 44A(f)(6)).

For social security tax purposes, child care or other domestic services performed in the taxpayer's home by the taxpayer's parent generally do not constitute "employment" (sec. 3121(b)(3)(B)). Also, services by the taxpayer's parent which are not performed in the course of the taxpayer's trade or business generally do not constitute employment, whether or not performed in the taxpayer's home. The Congress understood that the Internal Revenue Service took the position that child care services performed in a grandparent's home are not performed in the course of the taxpayer's trade or business. Under this view, both child care services performed by a grandparent in the taxpayer's home and child care services performed by a grandparent in the grandparent's home generally would not constitute "employment," and hence payments for such services would not qualify as expenses eligible for the child care credit.

However, services performed by a grandparent in caring for a child (living in the taxpayer's home) who is either under 18 or who is mentally or physically incapacitated may constitute "employment" if the taxpayer is a surviving spouse or is divorced and not remarried, or if the taxpayer has a mentally or physically incapacitated spouse who is unable to care for the child (sec. 3121(b)(3)(B)). In these circumstances, payments for child care services performed by the child's grandparents may have been eligible for the child care credit.

Services performed for the taxpayer by other relatives (other than by the taxpayer's child if under age 21) may constitute "employment" under the social security tax rules if a bona fide employer-employee relationship exists. Therefore, payments to these relatives may have qualified for the child care credit if neither the taxpayer nor the

taxpayer's spouse could claim a personal exemption deduction for the relative.

### ***Reasons for change***

The Congress believes that child care services provided by a taxpayer's adult relatives, particularly a child's grandparent, should qualify for the child care credit on the same basis as services performed by persons not related to the taxpayer, because relatives generally provide better attention and because allowance of the credit, especially for child care services performed by grandparents, will help to strengthen family ties.

### ***Explanation of provision***

The Act eliminates the requirement of prior law that child care services performed by relatives must constitute "employment" within the meaning of the social security tax definition in order to qualify under the child care credit provisions.<sup>1</sup> As a result, otherwise qualifying amounts paid by a taxpayer for care of his or her child by a grandparent of the child are eligible for the credit to the same extent as if paid to a person who is not related to the taxpayer.

The Act does not affect the rule of present law that disallows the child care credit for amounts paid to a relative (including amounts paid to a child or to a parent of the taxpayer) for whom the taxpayer or the taxpayer's spouse could claim the deduction for personal exemptions for dependents. It does not matter for this purpose whether the taxpayer or spouse in fact actually claims the dependency exemption deduction on a tax return; the credit is denied if either spouse could have claimed the deduction for the relative. As a result, no credit would be allowed for otherwise qualifying amounts paid by a taxpayer for child care services performed by a grandparent of the child if either the taxpayer or the taxpayer's spouse, for the year in which such services are performed, could claim a personal exemption deduction for the grandparent.

The Act provides that the credit is not allowed for amounts paid by the taxpayer to his or her child (including a stepchild) for child care services if the child being paid is under the age of 19 as of the close of the year in which the services are performed. The credit is not allowed for any such payments to the child under 19 whether or not either the taxpayer or the taxpayer's spouse could claim a personal exemption deduction for the child being paid for child care services. If the taxpayer's child is 19 or over by the end of the year, payments for child care services performed by the child qualify for the credit only if neither the taxpayer nor the taxpayer's spouse could claim a personal exemption deduction for the child performing the services.

The Congress intends that amounts paid by a taxpayer to his or her spouse to care for the taxpayer's child (including a stepchild) do not qualify for the child care credit. Because parents have the duty of caring for their children, it would be inappropriate to permit the credit for payments between spouses for child care.

<sup>1</sup> The Act does not make any change in the sec. 3121(b) (3) definition of "employment" for purposes of social security taxes.

***Effective date***

The change in the payments to relatives rule applies to taxable years beginning after December 31, 1978.

***Revenue effect***

This provision will reduce budget receipts by \$5 million in fiscal year 1979, \$38 million in fiscal year 1980, and \$39 million in fiscal year 1983.

## C. DEFERRED COMPENSATION PROVISIONS

### 1. State and Local Government Deferred Compensation Plans (sec. 131 of the Act and sec. 457 of the Code)

#### *Prior law*

A taxpayer using the cash receipts and disbursements method (cash method) of accounting generally is not required to include compensation in gross income until it is actually or constructively received (sec. 451). However, under the constructive receipt doctrine, a taxpayer may not deliberately turn his back on income and thus select the taxable year for which the income will be reported. A taxpayer ordinarily will be deemed to have received income if he or she has a right to receive that income and the exercise of that right is not subject to substantial restrictions (Treas. Regs. § 1.451-2(a)).

In addition, under certain conditions, a taxpayer is required to treat the receipt of noncash benefits as income. Under the cash method, a taxpayer is required to report any item of income that is received in cash or in the form of a "cash equivalent." (Treas. Regs. §§ 1.61-2(d), 1.446-1(a)(3), and 1.446-1(c)(1)(i).)

If property transferred as compensation is subject to a substantial risk of forfeiture and is nontransferable, rules are provided which defer income inclusion until the property first becomes transferable or not subject to a substantial risk of forfeiture (sec. 83). The same general rules which apply to the transfer of property in connection with the performance of services generally apply to funded, non-qualified, deferred compensation arrangements (sec. 402(b)).

In applying the constructive receipt and cash equivalent doctrines to deferred compensation, an unsecured promise to make a future payment, not represented by a note, is not an item of gross income under the cash receipts and disbursements method.<sup>1</sup> Further, some courts have held that neither the constructive receipt doctrine nor the cash equivalent doctrine applies to a taxpayer merely because the taxpayer agreed with the payor in advance to receive compensation on a deferred basis rather than currently, as long as the agreement was made before the taxpayer had obtained an unqualified and unconditional right to the income.<sup>2</sup>

In 1960, the Internal Revenue Service published Revenue Ruling 60-31<sup>3</sup> which set forth a broad policy statement regarding the applica-

<sup>1</sup> See *Jackson v. Smietanka*, 272 F.970 (7th Cir. 1921); *E. F. Cremin*, 5 B.T.A. 1164 (1927), acq. VI-1 C.B. 2 (1927); *C. Florian Zittel*, 12 B.T.A. 675, 677 (1928).

<sup>2</sup> See *James F. Oates*, 18 T.C. 570 (1952); *aff'd*, 207 F. 2d 711 (7th Cir. 1953). acq. (and prior nonacq. withdrawn) 1960-1 C.B. 5; *Howard Veit*, 8 T.C. 809 (1947), acq. 1947-2 C.B. 4; *cf. Kay Kimbell*, 41 B.T.A. 940 (1940), acq. and nonacq. 1940-2 C.B. 5, 12; *J. D. Amend*, 13 T.C. 178 (1949), acq. 1950-1 C.B. 1; *James Gould Cozzens*, 19 T.C. 663 (1953); *Howard Veit*, 8 CCH Tax Ct. Mem. 919 (1949).

<sup>3</sup> 1960-1 C.B. 174.



tion of the constructive receipt and cash equivalent doctrines to non-qualified deferred compensation arrangements.<sup>4</sup> Revenue Ruling 60-31 set forth a number of general principles regarding the constructive receipt and cash equivalent doctrines and then provided five examples of their application to deferred compensation arrangements.

The five examples set forth in the ruling made it clear that the constructive receipt and cash equivalent doctrines would not be applied to certain deferred compensation arrangements between an employee and an employer even though the employee might have obtained an agreement from the employer to make an immediate cash payment following the performance of services. Subsequent published rulings continued to confirm that the constructive receipt and cash equivalent doctrines would not be applied merely because an employee was permitted to elect, before the compensation was earned, to defer the compensation to a later time or receive it currently. In addition, some of these subsequent rulings indicated that a cash method employee would not be considered to have current income even though the employer set aside assets to fund its obligation to pay deferred compensation, as long as the employee did not acquire a present interest in either the amounts deferred or the assets used as the employer's funding medium.<sup>5</sup>

In 1972, the Internal Revenue Service issued the first favorable private letter ruling with respect to an unfunded deferred compensation arrangement where a State or local government unit was the employer.<sup>6</sup> Subsequently, many States and local governments have obtained private rulings with respect to their deferred compensation plans which provide that participating employees who use the cash method will include in income benefits payable under the deferred compensation plan only in the taxable year in which such benefits are received or otherwise made available.

<sup>4</sup> At the same time the Service withdrew its prior nonacquiescence and acquiesced in the decision in *James F. Oates, supra*. See 1960-1 C.B. 5.

<sup>5</sup> See Revenue Ruling 68-99, 1968-1 C.B. 193, where the employer purchased an insurance policy on the life of the employee to insure that funds would be available to meet its obligation to make deferred compensation payments. The ruling held that the employee did not receive a present economic benefit when the employer purchased the insurance contract since all rights to any benefits under the contract were solely the property of the employer and the proceeds of the contract were payable by the insurance company only to the employer.

See also Revenue Ruling 72-25, 1972-1 C.B. 127, where the employer funded its deferred compensation obligation with the purchase of an annuity contract.

<sup>6</sup> These deferred compensation plans typically involve an agreement between the employee and the State or local government, under which the employee agrees to defer an amount of compensation not yet earned. Frequently, these plans permit the employee to specify how the deferred compensation is to be invested by choosing among various investment alternatives provided by the plan. (However, the employer must be the owner and beneficiary of all such investments and the employee or his beneficiary cannot have a vested, secured, or preferred interest in any of the employer's assets.) Benefits under these plans (including gains and losses and investment income on investments made with the deferred compensation) typically are paid to the employees upon retirement or separation from service with the employer, or, in the case of the death of an employee, to the designated beneficiary. Typically, these plans provide also for the payment of benefits in case of an emergency beyond the employee's control. Many plans also provide for optional modes of distributing benefits (e.g., lump-sum payment or installments over 10 years) upon the occurrence of the event which causes benefits to be paid.

In April 1977, the Internal Revenue Service stopped issuing private rulings dealing with the income tax treatment of individuals under unfunded deferred compensation plans of the type typically established by State and local governments, and began advising applicants for rulings that their applications would be delayed pending study. (The plans involved permitted individuals to elect to defer a portion of salary that would otherwise be payable.) Later, the Service publicly announced<sup>7</sup> the suspension pending a review of the area.

After completion of its review of this area, the Internal Revenue Service issued proposed regulations<sup>8</sup> which provide generally that, if under a plan or arrangement (other than a qualified retirement plan), payment of an amount of a taxpayer's fixed, basic, or regular compensation is deferred at the taxpayer's individual election to a taxable year later than that in which the amount would have been payable but for the election, the deferred amount will be treated as received in the earlier taxable year. These proposed regulations would have applied to plans maintained by State and local governments, as well as plans maintained by tax-exempt organizations and taxable employers.

### ***Reasons for change***

The Congress believed that the regulations concerning nonqualified deferred compensation plans involving an individual election to defer compensation proposed by the Internal Revenue Service on February 3, 1978, if adopted in final form, would have had a serious impact upon the employees of many States and localities. If adopted, the regulations would have prohibited employees of State and local governments from participating in nonqualified, unfunded deferred compensation plans as a means of providing tax-deferred retirement income.

Although the Congress did not believe that State and local government employees should be totally prohibited from participating in unfunded deferred compensation plans, it concluded that limitations should be imposed on the amounts of compensation that can be deferred under these arrangements and allowed to accumulate on a tax-deferred basis. Accordingly, the Congress concluded that a percentage-of-compensation limit on amounts that can be deferred, as well as an absolute dollar limitation to prevent excessive deferrals by highly compensated employees, was necessary.

### ***Explanation of provision***

Under the Act, employees and independent contractors who provide services for a State or local government or a rural electric cooperative that maintains an eligible deferred compensation plan will be able to defer the inclusion in income of compensation as long as such deferral does not exceed the prescribed annual limitations. The rules prescribed by the Act apply whether or not employees and independent contractors are provided with an individual option to defer compensation.

### ***In general***

Amounts of compensation deferred by a participant in an eligible State deferred compensation plan, plus any income attributable to the investment of such deferred amounts, will be includible in the income

<sup>7</sup> IR-1881 (9/7/77).

<sup>8</sup> Prop. Regs. § 1.61-16, published in the *Federal Register* for February 3, 1978 (43 F.R. 4638).

of the participant or his beneficiary only when it is paid or otherwise made available. For this purpose, the fair market value of any property (including an annuity contract or a life insurance policy) distributed to the participant from the plan will be includible in income. Amounts deferred are not "made available" solely by reason of the fact that an individual can elect, prior to the time he obtains an unconditional right to receive an amount of compensation, to defer some portion of it until a future date. In addition, amounts will not be considered "made available" merely because the participant is permitted to choose among various options that the plan may provide for the investment of deferred amounts, or to elect, prior to the earliest distribution date provided under the plan, the manner in which deferred amounts are to be paid.<sup>9</sup> (However, because the Congress was concerned with preserving salary-reduction deferred compensation plans as a means of providing retirement income for employees of States and local governments and not as a means of deferring the receipt of income indefinitely, it is anticipated that the Secretary of the Treasury will prescribe rules concerning the time by which distributions must begin to be made from a plan and the length of time over which such payments can be spread.) Of course, if a participant actually assigns or alienates his benefit under a plan, the benefit is made available to him.

If life insurance is purchased with some, or all, of the amounts deferred under the plan, the cost of current life insurance protection will not be considered made available as long as the organization maintaining the plan (1) retains all of the incidents of ownership of the policy, (2) is the sole beneficiary under the policy, and (3) is under no obligation to transfer the policy or to pass through the proceeds of the policy, as such, to the participant or a beneficiary of the participant. However, if the plan provides a death benefit, whether or not funded by the employer through the purchase of life insurance on the participant, any such death benefit will not qualify for exclusion from gross income as life insurance proceeds under section 101(a) of the Code. Instead, it is intended that any death benefit will be taxed in accordance with the deferred compensation rules to the recipient.

#### *Plan requirements*

To qualify as an eligible State deferred compensation plan, the plan must be maintained by a State, a political subdivision of a State, an agency or instrumentality of a State or one of its political subdivisions, or a tax-exempt rural electric cooperative or one of its tax-exempt affiliates and must limit participation to *individuals* who perform services for it (i.e., partnerships and corporations cannot be participants).<sup>10</sup> In addition, the plan by its terms must not allow the deferral of more than \$7,500, or 33⅓ percent of the participant's includible compensation for the taxable year, whichever is less.

<sup>9</sup> Of course, it would be permissible for a participant merely to elect the time that benefit payments are to begin, and then, at a later date, to select among various payment options offered by the plan.

<sup>10</sup> While any deferred compensation arrangement between a State or local government and a partnership or service corporation would benefit the partners or shareholders who actually provide the services, it was considered unnecessary to extend the availability of such arrangements to these entities since they can provide deferred compensation through funded tax-qualified plans. In addition, a service corporation can maintain a nonqualified unfunded arrangement (without any limitations on the amount of compensation that can be deferred) for the benefit of its highly-compensated employees.

Includible compensation (rather than gross compensation) was used in determining the percentage of an employee's compensation that may be deferred because of the necessity of coordinating with the provisions of section 403(b) which also are based on includible compensation. In addition, there may be contractual deferred compensation arrangements where only includible compensation is readily determinable. For example, if a consultant agrees to provide service to a State agency for one year in return for current payments of \$25,000 plus payments of \$5,000 per year for an additional five years, such payments to begin after a period of ten years, it is clear that includible compensation is \$25,000, but until the present value of the right to receive the additional \$5,000 per year for 5 years is determined, compliance with the percentage limitation cannot be determined. (See discussion in *Present value of compensation* below.) Also, from the terms of the contract it generally would not be possible to tell how much compensation the consultant could have received in the year the services were performed ("gross compensation") but for the agreement to take periodic payments beginning at a later date.

For most employee-participants in the typical deferred compensation arrangement maintained by States or local governments, the determination of the permissible amount of deferral will not be burdensome since the compensation to be received for a particular year will be fixed by statute or contract and the employee will enter into a salary-reduction agreement with the employer that will specify how much is to be deferred. In the typical arrangement, the  $33\frac{1}{3}$  percent-of-includible-compensation limitation is equal to 25 percent of the compensation that would be received but for the salary reduction agreement. For example, an employee who is scheduled to receive \$12,000 during a taxable year could enter into a salary-reduction agreement and elect to defer \$3,000 (25 percent of gross compensation of \$12,000 and  $33\frac{1}{3}$  percent of includible compensation of \$9,000).

An eligible State deferred compensation plan may provide a limited "catch-up" provision for any, or all, of the last three taxable years of a participant ending before the normal retirement age specified by the plan (or if no normal retirement age is specified by the plan, then either the later of the normal retirement age specified in any other retirement plan maintained by the sponsoring entity or age 65.) Under the catch-up provision, in addition to the amount that may be deferred under the usual \$7,500 and  $33\frac{1}{3}$ -percent-of-includible-compensation limitations, a participant may defer an additional amount equal to any deferral limitations not utilized for prior taxable years in which the participant was eligible to participate in the plan (even if nothing was deferred) and was subject to the deferral limitations imposed by the Act. (Thus, taxable years of participants beginning before December 31, 1978 may not be utilized for purposes of determining any catch-up deferral permitted.) The maximum amount that can be deferred in any taxable year through the utilization of both the normal deferral limitation and the catch-up provision is \$15,000. (Of course, the deferred amount also cannot exceed the amount of the participant's compensation from the State, etc.) For example, a 62-year-old participant in a plan with a normal retirement age of 65 who is scheduled to receive a salary of \$20,000 during the next taxable year,

could elect to defer \$15,000 of that compensation if the prior year's deferral limitations have been underutilized by at least \$10,000. (The regular limitation is \$5,000 (\$20,000 minus \$5,000 deferral) divided by 3 equals \$5,000; the catch-up amount is \$10,000 (\$15,000 minus \$5,000).) As illustrated, the current year's deferral limitation based on includible compensation is determined without regard to the catch-up deferral.

The underutilized deferral limitation for a taxable year is the difference between compensation actually includible in income for that year and compensation that would have been includible in income if the maximum deferral limitation had been utilized. For example, an individual with a salary of \$20,000 who did not elect to defer any compensation would have an underutilized deferral limitation of \$5,000 (\$20,000 minus \$15,000 (includible compensation if the 33% percent deferral limitation had been utilized)). In calculating the underutilized deferral limitation, the participant must use the actual plan limitations if they are less than the limitations provided by the Act.

In addition to providing limitations on amounts of compensation that can be deferred, the Act provides that the plan must not permit participants to defer compensation for a calendar month unless an agreement providing for such deferral has been entered into before the beginning of such month.

An eligible State deferred compensation plan cannot make benefits available to participants before the earlier of (1) separation from service with the sponsoring entity,<sup>11</sup> or (2) the occurrence of an unforeseeable emergency. While the Secretary of the Treasury is to prescribe regulations defining what constitutes an unforeseeable emergency, it is not intended that such term would include the purchase of a home or the need for funds to send children to college. In addition, it is expected that plans will permit the withdrawal of only the amount of funds reasonably needed to satisfy the emergency needs.

Finally, for a deferred compensation plan to be eligible under the Act, all amounts of compensation deferred under the plan, all property or rights to property (including rights as a beneficiary of life insurance protection) purchased with the amounts deferred, and any income earned on property purchased with amounts deferred must remain assets of the plan sponsor subject to the claims of its general creditors. Thus, while plan participants may select among any optional methods provided under the plan for investing amounts of deferred compensation, they cannot have any secured interest in the assets purchased with their deferred compensation and assets may not be segregated for their benefit in any manner which would put an interest therein beyond the reach of the general creditors of the sponsoring entity.

Any plan which is not administered in accordance with the Act's requirements for eligible State deferred compensation plans will lose its eligible status on the first day of the first plan year beginning more than 180 days after written notification by the Secretary of the Treasury that such requirements are not being met, unless satisfactory corrective action is taken by the first day of such plan year. If a plan loses

<sup>11</sup> The Secretary of the Treasury will prescribe by regulations what constitutes "separation from service" for an independent contractor.

its status as an eligible State deferred compensation plan, amounts subsequently deferred by participants will be includible in income when deferred (unless the amounts are subject to a substantial risk of forfeiture when deferred). However, it is intended that amounts previously deferred, and any earnings thereon, will still not be includible in income until paid or otherwise made available.

*Participants in more than one eligible plan, or in a section 403(b) annuity*

Except for the limited "catch-up" provision, \$7,500 is the maximum compensation that can be deferred in a taxable year by an employee or an independent contractor who is a participant in an eligible State deferred compensation plan. This dollar limitation applies at the individual level, as well as at the plan level. Thus, if a person participates in more than one eligible plan (whether or not maintained by the same sponsoring entity) he must determine how the \$7,500 limitation will be allocated among the various plans in which he participates. If the \$7,500 limitation is exceeded, all excess amounts deferred for the taxable year will be currently includible in income.

If an individual participates in an eligible State deferred compensation plan and also has amounts contributed by an employer for the purchase of a tax-sheltered annuity or mutual fund shares held in a custodial account, and part or all of such contributions are excludable under section 403(b), the contributions excludable under section 403(b) reduce both the \$7,500 and the 33 $\frac{1}{3}$  percent of includible compensation limitations. For example, a public school official with a contract salary of \$30,000 in his or her first year of service with the school system could be eligible to participate in both an eligible State deferred compensation plan and a tax-sheltered (section 403(b)) annuity plan sponsored by the employer. If the employee elected to participate in the tax-sheltered annuity plan to the maximum extent possible while still participating in the eligible deferred compensation plan, he or she could elect to defer \$4,500 under section 403(b) for contributions used to purchase an annuity contract or mutual fund shares and \$3,000 under the eligible State deferred compensation plan.<sup>12</sup>

<sup>12</sup> The applicable limitations would be computed as follows:

(1) Sec. 403(b) exclusion for the tax-sheltered annuity— $20\% \times \$22,500$  (includible compensation after reduction of contract salary for amounts deferred under both plans)  $\times 1$  (one year of service) = \$4,500. (There is no reduction under sec. 403(b)(2)(A)(ii) for amounts contributed in prior years by the employer and excludable by the employee, since this is assumed to be the first year of service with the school system.) (The includible compensation of \$22,500 used in computing the limitations was determined by multiplying the contract salary of \$30,000 by 25 percent and subtracting that result (\$7,500) from \$30,000 since it was assumed that the maximum deferral possible was obtained by the employee.)

(2) The sec. 457(b)(2) limitation (limitation on deferral under an eligible State deferred compensation plan) is \$3,000, which is the lesser of—

- (a) \$7,500, or
- (b)  $33\frac{1}{3}\% \times \$22,500$  (includible compensation after reduction of contract salary by deferral under both plans),
- (c) \$7,500, as determined under (b), reduced by the exclusion of \$4,500 under sec. 403(b) = \$3,000.

For purposes of determining the exclusion allowance under section 403(b), any amount deferred in a prior taxable year of the employee under an eligible State deferred compensation plan (without regard to the sponsoring entity) will be treated as an amount contributed by the employer for annuity contracts and excluded by the employee, if the taxable year of deferral counts as a year of service in the computation of the exclusion allowance under section 403(b).<sup>13</sup>

*Treatment of participants in an ineligible plan*

If a deferred compensation plan fails to meet the requirements of an "eligible" plan, then all compensation deferred under the plan is includible currently in income by the participants unless the amounts deferred are subject to a substantial risk of forfeiture. If amounts deferred are subject to a substantial risk of forfeiture, then they are includible in the gross income of participants or beneficiaries in the first taxable year there is no substantial risk of forfeiture.

While amounts deferred under an ineligible State deferred compensation plan generally would be included in income in the year of deferral, earnings credited on such deferred amounts would not be subject to current taxation as long as the participant has no interest in the assets of the entity sponsoring the plan which is more secure than that of general creditors. Where the participant has no such interest, earnings on amounts deferred under the plan will not be taxable to the participant until paid or otherwise made available and then will be taxed according to the annuity rules (sec. 72). Of course, the distribution of an annuity contract purchased with the earnings will be taxable (based on the fair market value of the contract) just as if it had been distributed from a nonqualified pension or profit-sharing plan.

The tax treatment of participants in an ineligible State deferred compensation plan does not extend to participants in the State's regular retirement plan (whether or not qualified under sec. 401(a)). In addition, such treatment is not applicable whenever section 83 or 402(b) applies to the taxation of deferred compensation.

*Present value of compensation*

The Act provides that compensation is to be taken into account at its present value. This rule was provided for those cases where the amount of deferral for a particular taxable year is not readily ascertainable.

In the case of the normal salary reduction deferral agreement entered into between an employee and a State or local government, the

<sup>13</sup> In the example contained in footnote 11, if in year 2 the employee still had a contract salary of \$30,000 and elected to defer the maximum amount possible under a tax-sheltered annuity while not taking advantage of the deferral under an eligible State deferred compensation plan, the exclusion allowance under sec. 403(b) would be \$3,214.28, computed as follows:

(a)  $20\% \times \$26,785.72$  (Includible compensation) = \$5,357.14

(b)  $\times 2$  years of service = \$10,714.28

(c) less \$7,500 (\$4,500 excluded under sec. 403(b) in the prior taxable year and \$3,000 deferred under an eligible State deferred compensation plan in the prior taxable year)

(d) maximum exclusion allowance = \$3,214.28 (assuming no deferral under the eligible State deferred compensation plan in year 2).

amount withheld by the State or local government will be considered to be the present value of the compensation deferred. This amount will then be compared to the includible compensation for the taxable year to determine if the limitations on deferral have been satisfied for the taxable year. However, in the case of an independent contractor or an employee who performs services during a taxable year in return for some compensation payable currently and additional compensation payable in a later taxable year, it will be necessary, as of the close of the taxable year, to determine (without regard to any restriction other than one having a substantial risk of forfeiture) the present value of the right to receive the future payment or payments and compare that to the includible compensation for the taxable year to determine if the limitations on deferral have been satisfied.

If future payments are subject to a substantial risk of forfeiture, then they will not be valued until there is no longer a substantial risk of forfeiture. At the close of the first taxable year in which the future payments are no longer subject to a substantial risk of forfeiture, the present value of such payments must be compared to the includible compensation for such year to determine if the deferral limitations have been met.

### ***Effective date***

All plans to which section 457 applies (whether currently in existence or not) will have until January 1, 1982, to satisfy the plan requirements for classification as an eligible State deferred compensation plan. However, the limitations on amounts that can be deferred under such a plan will apply for all taxable years beginning after December 31, 1978. Thus, if a participant defers more than  $33\frac{1}{3}$  percent of includible compensation during his 1979 taxable year, all of the excess will be includible in income for 1979. (For taxable years beginning after 1981, such an excess deferral possibly could cause the plan to become ineligible, thus subjecting the entire deferral to current taxation.) In addition, the catch-up provisions will apply prior to 1982 only if all State deferred compensation plans in which a participant is participating, and has participated in during taxable years for which there is an underutilized deferral limitation, are "eligible" State deferred compensation plans (i.e., all plans involved actually satisfy the plan requirements of sec. 457(b)).

### ***Revenue effect***

This provision continues the existing tax treatment of these types of plans within certain limitations, and therefore it has a negligible revenue effect.



## 2. Certain Private Deferred Compensation Plans (sec. 132 of the Act)

### *Prior law*

The tax treatment of amounts deferred under unfunded, nonqualified deferred compensation plans maintained by taxable entities is basically the same as the treatment of amounts deferred under unfunded, nonqualified deferred compensation plans maintained by State and local government units. However, unfunded deferred compensation plans maintained by these entities do differ in that, under Title I of the Employee Retirement Income Security Act of 1974, they are limited to providing benefits in excess of those permitted under tax-qualified plans, or their coverage must be limited primarily to highly compensated and managerial employees.

The proposed regulations<sup>1</sup> issued by the Treasury Department on February 3, 1978, would have applied to nonqualified deferred compensation plans maintained by these entities, as well as to those maintained by State and local governments. Much uncertainty developed in the private plan sector because of the statement in the preamble to the proposed regulations that, if the regulations were adopted in final form, the Internal Revenue Service's acquiescences in the decisions in *James F. Oates*<sup>2</sup> and *Ray S. Robinson*<sup>3</sup> would be reconsidered. The Service also indicated that it would be necessary to examine the facts and circumstances of cases similar to those described in several published revenue rulings to determine whether the deferral of payment was in fact at the individual option of the taxpayers who earned the compensation.

One of the published rulings singled out by the Service involved a five-year employment contract between an employer and an executive employee under which a specified amount of compensation was to be credited to a bookkeeping reserve, accumulated, and then paid out in five equal annual installments beginning when the employee either (1) terminated employment with the employer, (2) became a part-time employee, or (3) became partially or totally incapacitated.<sup>4</sup> Because the example cited by the Service involved an employment contract and not an annual election to defer compensation, uncertainty was created in the private plan sector as to the effect of the proposed regulation.

### *Reasons for change*

In the case of a nonqualified deferred compensation plan maintained by a taxable employer, a deduction for the deferred compensation is postponed until the employee includes the compensation in income. Thus, in many situations, there would be no substantial net

<sup>1</sup> Prop. Treas. Regs. § 1.61-16, at 43 F.R. 4638.

<sup>2</sup> 18 T.C. 570 (1952).

<sup>3</sup> 44 T.C. 20 (1965).

<sup>4</sup> Example 1 of Revenue Ruling 60-31, 1960-1 C.B. 174.

change in tax receipts as a result of treating deferred compensation as currently taxable to an employee and currently deductible by an employer rather than deferring both inclusion by the employee and deductibility by the employer. Therefore, the Congress believed that the doctrine of constructive receipt should not be applied to employees of taxable employers as it would have been under the proposed regulations concerning nonqualified deferred compensation plans issued by the Treasury Department on February 3, 1978. The Congress also believed that the uncertainty surrounding the status of deferred compensation plans of taxable organizations caused by the proposed regulations was not desirable and should not be permitted to continue.

#### ***Explanation of provision***

The Act provides that the taxable year for including compensation deferred under a deferred compensation plan maintained by a taxable entity is to be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. It is intended that these principles are to be determined without regard to the proposed deferred compensation regulation under section 61 of the Code which was published in the Federal Register for February 3, 1978.

The Act is not intended to restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or interfere with judicial determinations of what principles of law apply in determining the timing of income inclusion.

#### ***Effective date***

This section is effective for taxable years ending on or after February 1, 1978.

#### ***Revenue effect***

This provision will have a negligible effect upon budget receipts.

### **3. Deferred Compensation Payments to Independent Contractors (sec. 133 of the Act and secs. 404(b) and 404(d) of the Code)**

#### ***Prior law***

An employer generally is permitted a deduction for deferred compensation provided under a nonqualified plan in the year that such compensation is includible in the employee's gross income<sup>1</sup> even though the employer is on the accrual basis and normally would be entitled to a current deduction. This rule applies to any method of contributions or compensation having the effect of a plan deferring the receipt of compensation.<sup>2</sup> However, it generally does not apply to an accrual basis taxpayer who defers payment of compensation until after the year of accrual, where the amount payable cannot be determined exactly until the later year (e.g., year-end bonuses which are computed as a percentage of pre-tax profits and are paid within a reasonable time after the close of the year).

Under prior law, the rule permitting a deduction for deferred compensation only when there was a corresponding income inclusion by a plan participant applied only where there was an employer-employee relationship. Thus, an accrual basis taxpayer generally was able to establish an unfunded deferred compensation plan for a cash basis independent contractor and obtain a deduction for such liability in accordance with the usual accrual accounting rules.

#### ***Reasons for change***

The Congress believed that the rules regarding the deductibility of deferred compensation should be the same whether employees or independent contractors are deferring the receipt of compensation.

The Congress also decided to make it clear that any nonqualified plan or arrangement which results in a deferral of the receipt of compensation is subject to the deferred compensation deduction-timing rules (sec. 404).

#### ***Explanation of provisions***

The Act adds a new provision (sec. 404(d)) which denies a deduction for deferred compensation provided under a nonqualified plan to non-employee participants, including cash-basis corporations, until that compensation is includible in the gross income of the participants. This rule is not intended to apply to normal year-end compensation accruals which are paid within a reasonable time after the close of the taxable year.

The Act clarifies current law by providing that a method of compensation or employer contributions having the effect of a plan deferring the receipt of compensation does not have to be similar to a stock bonus, pension, profit-sharing, or annuity plan to be subject to the deferred compensation deduction-timing rules (sec. 404). Under the

<sup>1</sup> Sec. 404(a)(5); Treas. Regs. § 1.404(a)-12(b).

<sup>2</sup> Treas. Regs. § 1.404(b)-1.

Act, amounts of compensation deferred under an employment contract or year-end bonuses declared by a corporate board of directors, but not paid within a reasonable period of time after the close of the taxable year, would be subject to the deduction-timing rules of section 404 to the extent that another Code provision (e.g., sec. 267(a)(2)) does not operate to deny the deduction.

Plans or arrangements which are not designed for the purpose of providing deferred compensation, or which do not have a substantial economic consequence of so providing, will not be subject to the deferred compensation deduction-timing rules. Thus, welfare benefit plans (for example, medical expense reimbursement plans), which do not have as a significant economic consequence the deferral of compensation, generally would not be subject to the deduction-timing rules.

With respect to the exception from application of the deduction-timing rule for accrued compensation paid within a reasonable time after the close of the taxable year, it is intended that the Treasury Department will prescribe rules for the application of the exception to accruals made under vacation pay plans and similar plans which are designed to provide, or have the economic consequence of providing, deferred compensation. In addition, it is intended that the Treasury Department will prescribe rules for any necessary coordination of the deduction-timing rules and the special vacation pay provisions (sec. 463). For this purpose, it is anticipated that accruals for vested vacation pay plans will be subject to no actual payment requirement for deductibility under the deduction-timing provision which is more stringent than required under section 463 for the deductibility or accrued vacation pay.

#### ***Effective date***

These provisions of the Act apply to deductions for taxable years beginning after December 31, 1978.

#### ***Revenue effect***

These provisions will have a negligible effect upon budget receipts.

#### **4. Tax Treatment of Cafeteria Plans (sec. 134 of the Act and sec. 125 of the Code)**

##### ***Prior law***

Under a "cafeteria plan" or "flexible benefit plan," an employee may choose from a package of employer-provided fringe benefits, some of which may be taxable (e.g., group-term life insurance in excess of \$50,000) and some of which may be nontaxable (e.g., health and accident insurance). Under a provision of the Employee Retirement Income Security Act of 1974 (ERISA), an employer contribution made before January 1, 1977, to a cafeteria plan in existence on June 27, 1974, was required to be included in an employee's gross income only to the extent that the employee actually elected taxable benefits. In the case of a plan not in existence on June 27, 1974, the employer contribution was required to be included in income to the extent the employee could have elected taxable benefits. Under the Tax Reform Act of 1976, these rules applied with respect to employer contributions made before January 1, 1978. The Foreign Earned Income Act of 1978 (P.L. 95-615) extended these rules until the effective date of this section of the Revenue Act (i.e., it extended the treatment through 1978 for calendar year taxpayers).

##### ***Reasons for change***

The provision in ERISA which prevented an employee from receiving tax-free treatment with respect to contributions to a cafeteria plan not in existence on June 27, 1974, and the provision of the 1976 Act extending the ERISA provision until January 1, 1978, were intended to be temporary and to allow further Congressional study of the tax treatment of cafeteria plans. The Congress decided that rules for the treatment of these plans should be provided on a permanent basis.

##### ***Explanation of provision***

###### ***General***

Under the Act, generally, employer contributions under a written cafeteria plan which permits employees to elect between taxable and nontaxable benefits are excluded from the gross income of an employee to the extent that nontaxable benefits are elected. For this purpose, nontaxable benefits include group-term life insurance up to \$50,000 coverage, disability benefits, accident and health benefits, and group legal services to the extent such benefits are excludable from gross income, but do not include deferred compensation.

The Act limits plan participation to individuals who are employees. In this regard, the Congress intended that a plan could include former employees as participants and could provide benefits for beneficiaries of participants.

In the case of a highly compensated employee (an employee who is an officer, a more-than-5-percent shareholder, or within the highest paid group of all employees, or an employee who is a spouse or de-

pendent of such an individual), amounts contributed under a cafeteria plan will be included in gross income for the taxable year in which the plan year ends, to the extent the individual could have elected taxable benefits unless the plan meets specified antidiscrimination standards with respect to coverage and eligibility for participation in the plan and with respect to contributions or benefits.

While it could be argued that a shareholder who controls a corporation always has the right to elect either taxable or nontaxable fringe benefits for himself by reason of controlling the corporation, it is not intended that the cafeteria plan rules apply in such a situation unless the election between taxable and nontaxable benefits is provided under the terms of a written arrangement.

#### *Coverage and eligibility*

A cafeteria plan will be considered to meet the coverage standards of the Act if it benefits a classification of employees found by the Secretary of the Treasury not to discriminate in favor of highly compensated employees. The plan will meet the eligibility standards of the Act if it (1) does not require an employee to complete more than three consecutive years of employment in order to become eligible to participate, and (2) allows an employee who is otherwise eligible to participate to enter the plan as a participant not later than the first day of the first plan year beginning after the date the employee completes three consecutive years of employment.

#### *Contributions or benefits*

The Act provides that a cafeteria plan must not discriminate as to contributions or benefits in favor of highly compensated employees. A plan will not be discriminatory if total benefits and nontaxable benefits attributable to highly compensated employees, measured as a percentage of compensation, are not significantly greater than total benefits and nontaxable benefits attributable to other employees (measured on the same basis), provided the plan is not otherwise discriminatory under the standards of the Act.

In the case of a cafeteria plan which provides health benefits, the plan will not be treated as discriminatory if: (1) contributions on behalf of each participant include an amount which equals either 100 percent of the cost of health benefit coverage under the plan of the majority of highly compensated participants who are similarly situated (e.g., same family size), or are at least equal to 75 percent of the cost of the most expensive health benefit coverage elected by any similarly situated plan participant, and (2) the other contributions or benefits provided by the plan bear a uniform relationship to the compensation of plan participants. The Congress intended that a cafeteria plan will not be considered to be discriminatory where the other contributions or benefits provided (or total contributions or benefits in the case of a plan which does not provide health benefits) for a highly compensated employee are a lower percentage of that employee's compensation than the plan provides for employees who are not highly compensated.

Under the Act, a plan is considered to meet all discrimination tests if it is maintained under an agreement which the Secretary of the Treasury finds to be a collective bargaining agreement between employee representatives and one or more employers.

In testing a cafeteria plan for discriminatory coverage of employees and discriminatory contributions or benefits, the Act provides that all employees who are employed by a commonly controlled group of businesses are treated as if they were employed by a single employer. The rules for aggregating employees of businesses under common control are the same as the rules which are used in testing tax-qualified pension plans for discrimination (sec. 414 (b) and (c)). The Congress intended that, where an employer maintains two or more cafeteria plans, the employer may choose to have the plans considered as a single plan for purposes of the discrimination tests.

***Effective date***

This provision is effective for taxable years beginning after December 31, 1978.

***Revenue effect***

This provision will have no effect upon budget receipts.

## **5. Certain Cash or Deferred Arrangements (sec. 135 of the Act and new secs. 401(k) and 402(a)(8) of the Code)**

### ***Prior law***

The benefits or contributions under a tax-qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated, and the plan must meet standards designed to assure that the classification of employees covered by the plan is not discriminatory. In the case of a tax-qualified cash or deferred profit-sharing plan, the employer gives an employee the choice of (1) being paid a specified amount in cash as current compensation, or (2) having that amount contributed to the plan. Rev. Rul. 56-497, 1956-2 C.B. 284, upheld the tax-qualified status of a cash or deferred profit-sharing plan where, in operation, over one-half of the employees who elected profit-sharing contributions (deferral), rather than current compensation, were among the lowest paid two-thirds of the employees who had met the plan's 3-year eligibility requirement. (See also Rev. Rul. 63-180, 1963-2 C.B. 189, and Rev. Rul. 68-89, 1968-1 C.B. 402.)

On December 6, 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of employees covered by cash or deferred profit-sharing plans. These proposed regulations were withdrawn in July, 1978. Under the rules in effect at the time of the proposal, an employee was not taxed currently on amounts he chose to have contributed to a tax-qualified cash or deferred profit-sharing plan.

In order to allow time for Congressional study of this area, section 2006 of the Employee Retirement Income Security Act of 1974 (ERISA) provided for a temporary freeze of the status quo. Under ERISA, the tax treatment of contributions to cash or deferred profit-sharing plans in existence on June 27, 1974, was governed under the law as it was applied prior to January 1, 1972,<sup>1</sup> and this treatment was to continue at least through December 31, 1976, or (if later) until regulations were issued in final form in this area, which would change the pre-1972 administration of the law.

In the case of plans not in existence on June 27, 1974, contributions to a cash or deferred profit-sharing plan were treated as employee contributions (until January 1, 1977, or until new regulations were prescribed in this area). This was intended to prevent a situation where a new plan might begin in reliance on pre-1972 law before Congress determined what the law should be in the future.

The Tax Reform Act of 1976 (sec. 1506) extended the temporary freeze of the status quo until January 1, 1978, in order to allow addi-

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<sup>1</sup> Accordingly, employer contributions to these cash or deferred profit-sharing plans were not includible in the income of covered employees, provided the plans satisfied the requirements of pre-1972 law and otherwise complied with the standards of the Code for tax-qualified plans.



tional time for Congressional study of this area. The Foreign Earned Income Act of 1978 (P.L. 95-615) extended these rules until the related provisions of the Revenue Act of 1978 are effective (i.e., it extended the treatment through 1979).

### ***Reasons for change***

Since the enactment of ERISA, the freeze of the status quo treatment of cash or deferred profit-sharing plans has prevented employers from setting up new plans of this type for their employees. Originally, it was thought that a relatively short period of time would be needed for Congressional study and that a permanent solution would be in place by January 1, 1977. The Congress concluded that the uncertainty caused by the state of the law had created the need for a permanent solution which would permit employers to establish new cash or deferred arrangements. Also, the Congress believed that prior law discriminated against employers who had not established such arrangements by June 27, 1974.

### ***Explanation of provision***

The Act adds new provisions to the Code (secs. 401(k) and 402(a)(8)) to permit employers to establish tax-qualified cash or deferred profit-sharing plans (or stock bonus plans). In addition, it provides a transitional rule to permit plans in existence on June 27, 1974 to rely on certain pre-1972 revenue rulings until plan years beginning in 1980.

The Act provides that a participant in a qualified cash or deferred arrangement will not have to include in income any employer contribution to the plan merely because he could have elected to receive such amount in cash instead. For the cash or deferred arrangement to be a tax-qualified plan, it must satisfy the usual profit-sharing or stock bonus plan qualification rules. In addition, it must satisfy the following requirements: (1) it must not permit the distribution of amounts attributable to employer contributions merely because of the completion of a stated period of plan participation or the passage of a fixed period of time (unlike profit-sharing plans in general, where distributions may be made in the third calendar year following the calendar year of the employer's contribution), and (2) all amounts contributed by the employer pursuant to an employee's election must be nonforfeitable at all times.

Special nondiscrimination rules are provided for these arrangements in lieu of the usual rules for testing discrimination in contributions to the plan. A cash or deferred arrangement will meet these nondiscrimination requirements for qualification for a plan year if (1) the actual deferral percentage<sup>2</sup> for the highest paid one-third

<sup>2</sup> In determining the actual deferral percentage of a participant, it is intended that both mandatory and optional deferrals are to be taken into account. Thus, a plan could be assured of satisfying the nondiscrimination requirement as to contributions if the employer contributions are allocated to participants in proportion to their base pay and at least two-thirds of the contribution allocated to each participant has to be deferred. However, it is not intended that a plan will be permitted to require a larger mandatory deferral percentage for lower-paid participants than it requires for higher-paid participants (e.g., it could not require 50-percent deferral for the lowest paid two-thirds of the participants and permit the highest paid one-third of the participants to defer whatever percentage they chose).

of all participants does not exceed the deferral percentage for the other eligible employees by more than 50 percent, or (2) the actual deferral percentage for the highest paid one-third of all participants does not exceed the actual deferral percentage of the other eligible employees by more than three percentage points. (If this latter test is used, the actual deferral percentage for the highest paid one-third cannot exceed the actual deferral percentage of all other eligible employees by more than 150 percent.<sup>3</sup>) In determining the highest paid one-third of all participants, only amounts considered as compensation under the provisions of the plan are taken into account. Therefore, the plan will have to have participation by employees in the lower paid group in order to obtain any deferral for the highest paid one-third.

### ***Effective date***

This provision is effective for taxable years beginning after December 31, 1979; however, a transitional rule is provided for those cash or deferred arrangements in existence on June 27, 1974, under which their qualified status for plan years beginning before January 1, 1980 will be determined in a manner consistent with Rev. Rul. 56-497 (1956-2 C.B. 284), Rev. Rul. 63-180 (1963-2 C.B. 189), and Rev. Rul. 68-89 (1968-1 C.B. 402).

### ***Revenue effect***

This provision will have a negligible effect upon budget receipts.

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<sup>3</sup> This requirement prevents a plan from permitting lower-paid participants to elect to take all of their allocated contributions in cash while permitting higher-paid participants to defer the portion of their allocated contributions equal to 3 percent of compensation.

## D. EMPLOYEE STOCK OWNERSHIP PLANS

### 1. Employee Stock Ownership Plans (sec. 141 of the Act and secs. 46, 48, 56, and 4975 and new secs. 409A and 6699 of the Code)

#### *Prior law*

##### *ESOPs in general*

An employee stock ownership plan is a technique of corporate finance designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay on their parts, any reduction in pay or other employee benefits, or the surrender of any rights on the part of the employees. The employee generally is not taxed on employer contributions to an employee stock ownership plan until they are distributed under the plan.

Under an employee stock ownership plan, a trust generally acquires common stock of the employer. (The trust may also acquire other equity securities of the employer, as well as certain bonds, debentures, notes and other evidences of indebtedness.) Generally, stock is acquired either through direct employer contributions or with the proceeds of a loan made to the plan (sec. 4975(e)(7)). Under prior law this type of plan was generally called an ESOP or leveraged ESOP.

Under prior law, regulations required that if a plan participant received employer securities from an ESOP, the employee was also to receive a "put option" (i.e., an option to require the employer to repurchase the stock at a specified price) if the stock was not publicly traded.

##### *TRASOPs*

Under prior law, an employee stock ownership plan to which an employer contributed stock (or cash) in order to qualify for additional investment tax credit was generally called a TRASOP. The TRASOP provisions were to expire after December 31, 1980.

All TRASOPs have to meet certain statutory requirements. Under prior law, an employee who participated in a TRASOP at any time during the year for which an employer contribution was made was entitled to have a share of the employer contribution credited to his or her TRASOP account based upon the amount of the employee's compensation from the employer.<sup>1</sup> Also, a plan participant was entitled to direct the voting of employer stock allocated to his or her account under a TRASOP, whether or not such stock was registered under Federal securities laws.<sup>2</sup>

<sup>1</sup> Only the first \$100,000 of an employee's compensation is considered for this purpose.

<sup>2</sup> Under prior law, there were no voting requirements with respect to stock held by an ESOP or any other type of qualified plan other than a TRASOP.

In addition to these requirements, which had to be met by all TRASOPs, a TRASOP could be a tax-qualified plan only if it met the other requirements applicable to tax-qualified retirement plans. However, TRASOPs were not required to be tax-qualified under prior law. Even if a TRASOP was not a tax-qualified plan it had to satisfy special rules with respect to employee participation and limitations on contributions and benefits which were the same as those for tax-qualified plans.

A TRASOP had to be established within the taxable year for which the additional investment tax credit was claimed in order to be considered a tax-qualified plan for that year. However, a TRASOP could be established as late as the date for filing the employer's tax return for a year (including extensions) in order for the additional investment tax credit to be claimed for the year. Therefore, under prior law, a TRASOP might have been nonqualified for its first plan year and qualified thereafter.

The employer's contribution to a TRASOP must be in the form of employer securities or cash (provided the cash is used by the TRASOP to acquire employer securities). Under prior law, the securities contributed to (or purchased by) a TRASOP were required to be common stock with voting power and dividend rights no less favorable than the voting power and dividend rights of other common stock of the issuing corporation. Securities convertible into such common stock could also be contributed.

An employer could contribute stock of another corporation to a TRASOP, provided that the two corporations were under at least 80 percent common control. However, gain or loss may have been recognized where a corporation made a TRASOP contribution in other than its own stock.

The amount of additional investment tax credit contributed to a TRASOP reduces an employer's income tax liability. Under prior law, this reduction in income tax could result in an increased minimum tax liability, even though the employer's income tax savings was offset by its contribution to the TRASOP.

Under prior law, where an investment tax credit amount for a year was recaptured with the result that the credit originally claimed for the year was later decreased, the employer had three alternatives with respect to adjusting the TRASOP contribution: (1) the amount of the decrease could be applied to offset employer contributions for other years; (2) the amount of the decrease could be deducted; or (3) the decrease could be used as the basis for a withdrawal from the TRASOP.

Under prior law, the type of distribution that could be made from a leveraged ESOP or a TRASOP depended on the nature of the particular plan (i.e., profit sharing, stock bonus, etc.).

### ***Reasons for change***

The ESOP provisions and the TRASOP provisions have been part of the tax laws for several years. Experience in the operation of these provisions indicated that several changes were appropriate. In addition, based on experience since the Tax Reduction Act of 1975, the Congress determined that the TRASOP provisions should be extended and should be made a part of the Code.

Statutory and administrative rules developed with respect to TRASOPs which were different from those rules which apply to tax-qualified plans in general. The Congress believed that the interests of uniformity would best be served if, in general, TRASOPs were required to become tax-qualified under the same standards generally applicable to tax-qualified plans. This requirement also should help employers maintaining TRASOPs to obtain interpretations of statutory provisions, since long-standing interpretations are available with respect to many of the rules governing tax-qualified plans.

Often, an employer does not establish a TRASOP until the time prescribed by law for filing its return for the year (including extensions), since the TRASOP does not have to be established before that time for the employer to claim the additional investment tax credit. Because of the requirement that a tax-qualified plan be established by the close of a taxable year in order to be tax-qualified for that year, many TRASOPs are not tax-qualified for their initial plan year. Since tax qualification for TRASOPs for all future years is required under the Act, the Congress believes that a TRASOP established on or before the due date for an employer's tax return for a year (including extensions), and which otherwise qualifies, should be treated as tax-qualified for that year. The Congress does not intend, however, to change the prior law rule requiring that tax-qualified plans other than TRASOPs be established before the close of a taxable year to be tax-qualified for that year. Consequently, no deduction is allowed for a taxable year for contributions to a plan which was not in existence at the close of that year.

The Congress believes that undue complexity has resulted from the prior law provision requiring that contributions to a TRASOP for a plan year be allocated to all plan participants irrespective of their service with the employer for that plan year. The Act therefore replaces this provision with the general rule for tax-qualified plans for determining which participants are required to share in a contribution for a plan year.

The Congress recognized that giving participants in leveraged ESOPs and TRASOPs full voting rights with respect to shares allocated to their accounts may be unduly burdensome in the case where the corporation issuing the employer securities is closely held. However, the Congress also recognized the general need of leveraged ESOP and TRASOP participants for voting rights on closely held employer securities with respect to major corporate issues (such as mergers, acquisitions, consolidations, or sales of all or substantially all of the assets of a corporation).

Many subsidiary corporations were unable to establish TRASOPs with the stock of their parent corporations because the parent corporations did not meet the 80-percent stock ownership requirement of prior law. The Congress concluded that this 80-percent requirement was unduly restrictive and that the interests of the public in broader employee stock ownership would better be served by a 50-percent stock ownership requirement. At the same time, a 50-percent requirement will provide a sufficient identity of interests between a parent corporation and a subsidiary corporation to make it reasonable to consider the stock of the parent corporation as employer securities of the subsidiary corporation.

The TRASOP provisions of prior law permitted subsidiary corporations to make contributions to TRASOPs of stock of their parent corporations. However, under prior law, it was not clear whether gain or loss was recognized with respect to such contributions. The Congress believed that it is inappropriate for the benefit of the additional investment tax credit to be offset by tax on gain recognized under these circumstances.

In certain cases, the additional investment tax credit attributable to TRASOP contributions could have increased an employer's minimum tax liability under prior law. The Congress concluded that this result was not appropriate because the benefit of the credit is offset by the contribution of the employer.

The Congress decided that any participant (or beneficiary) who receives a benefit distribution from a leveraged ESOP or a TRASOP should be able to dispose of the distributed employer securities for cash. The Congress recognized that in some cases this conversion occurs almost simultaneously with the actual distribution. The Congress concluded that the administrative paperwork and expense which is required for the leveraged ESOP or TRASOP to make a distribution in employer securities and then immediately repurchase the securities for cash is unwarranted in these cases. Accordingly, the Congress believed that this process should be simplified when the leveraged ESOP or TRASOP wants to distribute benefits in cash. However, if a participant wishes to receive this benefit in securities of the employer, and retain ownership of these securities, he should be able to do so, and he should have the future right to convert the securities to their cash equivalent through a "put option" to the employer if the securities are not readily tradeable on an established market.

### ***Explanation of provisions***

#### *General*

The Act changes the meaning of the term "ESOP." The type of plan previously referred to as a TRASOP (or investment tax credit ESOP) is designated as an ESOP. The type of plan previously referred to as an ESOP or leveraged ESOP is designated as a leveraged employee stock ownership plan. For purposes of this explanation the new terminology is used.

The Act (1) made several amendments to the provisions of law which deal with ESOPs and with leveraged employee stock ownership plans, (2) made the ESOP provisions as amended by the Act, part of the Code for the first time, and (3) extended the expiration date of the ESOP provisions to December 31, 1983.

#### *Qualification requirements for ESOPs*

Under the Act, all ESOPs are required to be tax-qualified plans. This represents a departure from the prior law provision which allowed ESOPs to be nonqualified provided that they met certain specified statutory standards. The Congress expects that the regulations which generally apply to tax-qualified plans will henceforth also apply to ESOPs, and that the Treasury Department will not write separate regulations regarding the application of the tax-qualification standards to ESOPs, except where ESOPs are distinguished from other qualified plans by statute.

Under the Act, an ESOP may be treated as tax-qualified from its effective date even though the ESOP is not actually established until the date for filing the employer's tax return for its taxable year (including extensions).

#### *Allocation of ESOP contributions*

Because ESOPs are now subject to the qualification requirements generally applicable to tax-qualified plans, employer contributions to an ESOP for a plan year generally are to be allocated in accordance with the rules governing the allocation of contributions under tax-qualified defined contribution plans. However, the Act retains the requirement that the allocation of employer contributions to an ESOP for a year must be made in proportion to the total compensation of all participants sharing in the allocation for the plan year, taking into account only the first \$100,000 of compensation for an employee.

#### *Provisions relating to employer securities*

The Act provides that if a leveraged employee stock ownership plan or an ESOP holds employer securities issued by a corporation the stock of which is registered under Federal securities laws, the plan must provide that the plan participants are entitled to exercise voting rights with respect to such employer securities. The Act also provides that if a leveraged employee stock ownership plan or an ESOP holds employer securities issued by a corporation the securities of which are not registered under Federal securities laws, the plan must provide that the plan participants are entitled to exercise voting rights with respect to such employer securities on any corporate issue which must by law (or charter) be decided by more than a majority vote of outstanding common shares voted on the issue.

The Act provides that, in the case of an ESOP, the only types of employer securities which may be acquired and held by the plan are (1) common stock of the issuing corporation and (2) preferred stock of the issuing corporation which is readily convertible into its common stock. The shares acquired by an ESOP, other than shares which are readily tradeable on an established securities market, must, in the aggregate, have a combination of (1) voting rights equivalent to rights possessed by shareholders of the class of common stock of the issuing corporation having the greatest voting rights, and (2) dividend rights equivalent to rights possessed by shareholders of any other class of stock of the issuing corporation having the greatest dividend rights. Thus, an ESOP or a leveraged employee stock ownership plan could satisfy this requirement if it holds a mixture of employer securities which reasonably reflects the outstanding securities of the employer.

The Act modifies the definition of employer securities for purposes of the ESOP provisions by applying a 50-percent test in lieu of the present law 80-percent test in determining whether corporations are members of the same parent-subsidiary controlled group of corporations. Under the Act, the stock of a parent corporation in a parent-subsidiary controlled group of corporations (determined by applying the 50-percent test) may be contributed as employer securities by a subsidiary to its ESOP. The Act does not disturb the present law rule under which an 80-percent test is applied in determining whether corporations are members of the same brother-sister controlled group for purposes of defining employer securities.

The Act provides that in a case where a parent corporation controls a subsidiary corporation (including a second tier subsidiary) under an 80-percent test for control, the subsidiary corporation will not recognize gain or loss on a contribution of stock of the parent corporation to an ESOP maintained by the subsidiary. The Act does not affect prior law applicable to other transactions.

#### *Minimum tax*

The Act provides that in any case where an employer claims additional investment tax credit as a result of an ESOP contribution, the additional credit will not result in the imposition of additional minimum tax on the employer. The Act makes no change in the present law provision under which each dollar of investment tax credit (other than investment tax credit attributable to ESOP contributions) may increase the base for computing the minimum tax.

#### *Prohibition of withdrawal of ESOP contributions on recapture*

The Act repeals the prior law rule permitting an employer to withdraw from an ESOP a contribution attributable to additional investment tax credit which is recaptured. Under the Act, an ESOP contribution made with respect to a particular qualified investment may not be withdrawn if all or a portion of the credit is later recaptured due to an early disposition of the property which gave rise to the credit. Under the Act, as under prior law, an employer may either (1) deduct the amount of the contribution attributable to the recaptured additional investment tax credit for the taxable year in which the recapture occurs, or (2) apply the amount of the contribution attributable to the recaptured additional investment tax credit against its obligation for a future ESOP contribution.

#### *Distributions from ESOPs and leveraged employee stock ownership plans*

Under the Act, a participant in a leveraged employee stock ownership plan or an ESOP who is entitled to a distribution under the plan is given the right to demand that the distribution be made in the form of employer securities rather than in cash (or other property). Subject to a participant's right to demand a distribution of employer securities, the plan may elect to distribute the participant's interest to him in cash, in employer securities, or partially in cash and partially in employer securities. Each participant should be advised in writing of the right to require a distribution of employer securities, before the leveraged employee stock ownership plan or the ESOP makes a distribution.

#### *Put option on stock distributed from ESOP or leveraged employee stock ownership plan*

Under the Act, any participant who receives a distribution of employer securities from an ESOP or a leveraged employee stock ownership plan must be given a "put option" on the distributed employer securities if the employer securities are not readily tradeable. The put option which a participant receives should have the following terms:

1. Upon receipt of the employer securities, the distributee must be given up to six months to require the employer to repurchase the



securities at their fair market value. Although the obligation to repurchase securities under the put option would apply to the employer, and not the ESOP or the leveraged stock ownership plan, it is permissible for the ESOP or leverage stock ownership plan to make the purchase in lieu of the employer. If the distributee does not exercise the initial put option within the six-month period, the option would temporarily lapse.

2. After the close of the employer's taxable year in which the temporary lapse of a distributee's option occurs and following a determination of the value of the employer securities (determined in accordance with Treasury regulations) as of the end of that taxable year, the employer is required to notify each distributee who did not exercise the initial put option in the preceding year of the value of the employer securities as of the close of the taxable year. Each such distributee must then be given up to three months to require that the employer repurchase his or her employer securities. If the distributee does not exercise this put option, the option permanently lapses.

3. At the option of the party repurchasing employer securities under the put option, securities can be repurchased on an installment basis over a period of not more than five years. If the distributee agrees, the repurchase period can be extended to a period of ten years. As security for an installment repurchase, the seller must be given a promissory note (or a secured obligation), the full payment of which could be required by the seller if the repurchaser defaults on any scheduled installment payment. In addition, if the term of the installment obligation exceeds five years, the employee must be given adequate security during the years in excess of the five years for the outstanding amount of the note.

4. Because a participant might wish to contribute a distribution from an ESOP or a leveraged employee stock ownership plan to an IRA in a "tax-free" rollover and because the contribution would have to be made before the expiration of the first six-month put option period, an IRA trustee or custodian must be able to exercise the same put option as the participant.

### ***Effective date***

The provisions generally apply with respect to qualified investments made after December 31, 1978.

### ***Revenue effect***

Since the ESOP provisions apply under present law until 1980, there is no revenue effect from extending these provisions through 1980. (The modifications to the provisions under the Act have only an insignificant revenue effect since they are primarily intended to make the existing provisions work more effectively.)

By extending the ESOP provisions through 1983, it is estimated that this provision will reduce budget receipts by \$178 million in fiscal year 1981, \$446 million in fiscal year 1982, and \$545 million in fiscal year 1983.

## **2. Estate Tax Exclusion for Certain Lump Sum Distributions (sec. 142 of the Act and sec. 2039 of the Code)**

### ***Prior law***

Under prior law, it was unclear whether a death benefit distribution from a tax-qualified plan, which could be treated as a lump sum distribution, was eligible for the estate tax exclusion generally applicable to death benefit distributions from qualified plans. Denial of the estate tax exclusion could have applied whether or not the recipient actually elected to treat the distribution as a lump sum distribution to which favorable income tax treatment applies.

### ***Reasons for change***

The Congress concluded that an estate tax exclusion should be provided with respect to a lump sum distribution where the recipient agrees to forego favorable income tax treatment (capital gains and ten-year averaging) with respect to the distribution.

### ***Explanation of provision***

The Act provides that a lump sum distribution under a qualified plan is excludable from the estate of the deceased plan participant if the recipient elects to forego favorable income tax treatment (i.e., the recipient must elect to forego 10-year averaging and capital gains treatment).

It is intended that benefits payable to a surviving spouse under a tax-qualified plan will not be disqualified for purposes of the estate tax marital deduction merely because of the existence of an election to receive deferred payments. For example, the mere existence of an election to receive an annuity for life or a definite period will not result in treating the surviving spouse's interest in benefits payable under a tax-qualified plan as a terminable interest which is ineligible for the marital deduction. Thus, if a surviving spouse elects 10-year averaging for a lump-sum distribution for income tax purposes (sec. 402(e)(4)) and, therefore, the distribution is ineligible for the estate tax exclusion for annuities payable under tax-qualified plans (sec. 2039), the distribution may be eligible for the estate tax marital deduction (sec. 2056) although an election was available under the plan to receive terminable survivor annuity payments. In addition, the mere existence of an election to choose between special 10-year averaging for lump sum distributions or the estate tax exclusion is not intended to affect eligibility of other property for the estate tax marital deduction although the amount of the other property passing to a surviving spouse may be affected by the election. For example, probate property passing to a surviving spouse under a maximum marital deduction formula bequest will not be ineligible for the marital deduction as a terminable interest merely because the value of such property passing to the surviving spouse may depend upon the lump sum distribution election.

***Effective date***

The provision applies to estates of decedents dying after December 31, 1978.

***Revenue effect***

This provision will have little or no effect on budget receipts.

### **3. Voting Rights on Employer Securities Held by Qualified Defined Contribution Plans (sec. 143 of the Act and sec. 401(a)(22) of the Code)**

#### ***Prior law***

Under prior law, tax-qualified defined contribution plans generally were not required to pass through to plan participants the voting rights on employer securities allocated to their accounts.

#### ***Reasons for change***

The Congress has concluded that when employer securities in closely held corporations are held by tax-qualified defined contribution plans, the plan participants should be permitted to exercise voting rights with respect to the securities on major corporate issues. This will relieve plan fiduciaries from having to vote on these difficult issues and will afford plan participants an important incident of share ownership.

#### ***Explanation of provision***

The Act provides that a tax-qualified defined contribution plan which is established by an employer whose securities are not publicly traded and which, allowing any acquisition of employer securities after December 31, 1979, holds more than 10 percent of its assets in employer securities must provide that the plan participants are entitled to exercise voting rights with respect to employer securities held by the plan on any corporate issue which must by law (or charter) be decided by more than a majority vote of outstanding common shares voted on the issue.

#### ***Effective date***

The provision applies to acquisitions of employer securities after December 31, 1979.

#### ***Revenue effect***

This provision will have little or no effect on budget receipts.

## **E. RETIREMENT PLAN PROVISIONS**

### **1. Simplified Employee Pensions (sec. 152 of the Act and secs. 219, 401, 404, 408, 414, and 415 of the Code)**

#### ***Prior law***

Under prior law and present law, a trust forming a part of a qualified pension, profit-sharing, or stock bonus plan is exempt from tax, employer contributions to the plan are deductible (within limits) in the year for which they are paid, employees generally are not taxed on benefits under the plan until the benefits are distributed or made available to them, 10-year forward income averaging and tax-free rollover treatment applies to lump sum distributions from a qualified plan, and special estate and gift tax exclusions are provided. Qualified plans are required to report financial and other information to plan participants and the Federal Government annually, and are required to provide plan participants with a summary plan description and a summary annual report. Also, prior law and present law provide Federal fiduciary standards and self-dealing prohibitions for qualified plans. Qualified plans are not permitted to discriminate in favor of employees who are officers, shareholders, or highly compensated.

Prior law and present law also provide for IRAs (individual retirement accounts, individual retirement annuities and individual retirement bonds) under which deductible contributions are limited to the lesser of 15 percent of earned income or \$1,500 (\$1,750 in the case of spousal IRAs). Employers may establish and maintain employer-sponsored individual retirement accounts or annuities for employees. IRAs are tax-exempt and amounts held in an IRA owned by an individual are generally not taxed to him or her until they are distributed. Reporting requirements with respect to IRAs are considerably less burdensome than those that apply to qualified pension plans. Fiduciary standards and self-dealing prohibitions are generally more easily complied with under an employer-sponsored IRA than under most qualified plans.

#### ***Reasons for change***

Many qualified pension plans have been terminated in the recent past. This may be due, in part, to the detailed rules these plans are required to satisfy. In addition, it may be that these rules have had the effect of retarding the introduction of new pension plans. Because of the expense and effort required to comply with present rules for tax-qualified plans, many employees, particularly the employees of small businesses, will not earn employer-provided retirement benefits.

Many of the complex rules of the pension law are provided to give employers flexibility to tailor retirement plans to the particular needs of their businesses. Accordingly, where an employer does not require this flexibility, more simplicity can be obtained by using IRAs instead of a pension plan.

## ***Explanation of provision***

### *In general*

The Act raises the deduction limit for individual retirement accounts and individual retirement annuities to \$7,500 or 15 percent of compensation (whichever is less), if the account or annuity qualifies as a simplified employee pension. The \$7,500 limit applies only to employer contributions to a simplified employee pension.

The deduction for employer contributions to an individual's simplified employee pension is allowed to an individual even though he or she is an active participant in a qualified plan, a tax-sheltered annuity, or a governmental plan. In other respects, however, the Act does not change the prior law limits on deductions for contributions to IRAs. Accordingly, if employer contributions to an individual's simplified employee pension for a year are less than the usual limit on deductible IRA contributions, the individual could make up the difference by making deductible contributions to an IRA if he or she is not an active participant in a qualified plan, etc., for that year.

Under the Act, an individual retirement account or individual retirement annuity maintained by an employee qualifies as a simplified employee pension for a calendar year if requirements of the Act as to withdrawals and the employer's allocation formula are satisfied.

### *Special rules*

***Withdrawals.***—Under the Act, employer contributions to a simplified employee pension may not be conditioned upon the retention of the contribution (or earnings on the amount contributed) in the pension and no prohibition on withdrawals may be imposed by the employer. Of course, the usual IRA rules determine the taxability of withdrawals from a simplified employee pension.

***Allocation formula.***—The Act requires a definite written formula for allocating employer contributions to simplified employee pensions. Under the formula, allocations are generally required to be made to simplified employee pensions for a calendar year for each employee who (1) has attained age 25, and (2) has performed service for the employer during the calendar year and at least 3 of the immediately preceding 5 calendar years. However, the Act permits the allocation formula to exclude employees within a collective bargaining unit or employees who are nonresident aliens, under the same rules which permit the exclusion of such employees from participation in qualified pension plans (sec. 410(b)(2)(A) and (C)). As in the case of qualified profit-sharing plans, the Act does not require an allocation for a year to an individual who is not employed on a specified date during the year unless prohibited discrimination will result from the failure to allocate to such an individual or individuals.

Under the Act, the employer's allocation formula must not discriminate in favor of employees who are officers, shareholders (more than 10 percent, directly or indirectly (sec. 318)), or highly compensated. The Act provides that, for this purpose, employer contributions are considered to be discriminatory unless they bear a uniform relationship to the total compensation (not in excess of the first \$100,000) for each employee who is entitled to share in the allocation of contributions to simplified employee pensions.

The Act provides that, under the discrimination test, taxes paid by an employer with respect to an employee under the Federal Insurance Contributions Act (sec. 3111) may be taken into account as employer contributions to the employee's simplified employee pension. However, under the Act, if such taxes are taken into account as employer contributions, the tax on self-employment income of each owner-employee must also be taken into account as an employer contribution under the discrimination test, and the \$7,500 limit on deductions for an officer, shareholder, or owner-employee is reduced by the amount of the taxes taken into account.

Under the Act, in testing an employer's allocation formula, employees of commonly controlled enterprises are considered to be employed by a single employer. Also, in applying the eligibility and discrimination rules (secs. 401(a)(4) and 410(b)) to a qualified plan maintained by an employer, simplified employee pensions may be treated as a qualified plan.

*Employer deductions.*—Under the Act, employer contributions to simplified employee pensions for a calendar year are deductible for the employer's taxable year with which (or within which) the calendar year ends. The amount deductible is limited to 15 percent of the compensation paid to the employees who share in allocations for that calendar year (accordingly, calendar year contributions are matched with calendar year compensation). Contributions made within 3½ months after the close of a calendar year may be treated by the employer as if they were made on the last day of that calendar year if they are made on account of that calendar year. Contributions which exceed the deductible limits for a taxable year may be carried over by the employer and deducted in subsequent taxable years.

Employer contributions to simplified employee pensions for a taxable year reduce the limitation on deductions for employer contributions to a plan covering a self-employed individual, or to a profit-sharing or stock bonus plan for that taxable year.

*Limits on benefits and contributions.*—Employer contributions to simplified employee pensions are taken into account as employer contributions to a defined contribution plan under the limitations on benefits and contributions under qualified plans (sec. 415). The special limits applicable to contributions under simplified employee pensions are not intended as a precedent for establishing reduced limitations on contributions for employees under qualified plans of small business employers or other employers.

*Reports.*—The Act provides for simplified employer reports to the Internal Revenue Service and to employees with respect to simplified employee pensions.

### ***Effective date***

The simplified employee pension rules apply to taxable years beginning after December 31, 1978.

### ***Revenue effect***

This provision will reduce budget receipts by \$6 million in fiscal year 1979, \$18 million in fiscal year 1980, and \$49 million in fiscal year 1983.

## **2. Defined Benefit Plan Limits (sec. 153 of the Act and sec. 415 of the Code)**

### ***Prior law***

Under prior law, the annual benefit expressed as a straight life annuity for a participant under a qualified defined benefit pension plan was not permitted to exceed the lesser of \$75,000 (adjusted for inflation since 1974) or 100 percent of the participant's average compensation for his highest paid three consecutive years of participation. In the case of a plan participant with fewer than 10 years of service, this limitation was reduced by one-tenth for each year of service less than ten.

### ***Reasons for change***

In situations involving rank-and-file participants in certain collectively bargained plans which do not base benefits on compensation, the 100 percent of compensation limitation has proved too restrictive.

### ***Explanation of provision***

Under the Act, the 100-percent-of-compensation limit is disregarded in the case of an employee who participates in a collectively bargained defined benefit pension plan covering at least 100 participants where specified requirements are satisfied. If the 100-percent-of-compensation rule is disregarded for a participant, under the Act, the \$75,000 limit on annual benefits is reduced to \$37,500 (adjusted for inflation since 1974).

### ***Effective date***

The provision applies for years beginning after December 31, 1978.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million annually.



### **3. Custodial Accounts for Regulated Investment Company Stock (sec. 154 of the Act and sec. 403 of the Code)**

#### ***Prior law***

Under present law and prior law, amounts paid by a tax-exempt charitable organization or a public educational institution to purchase an annuity contract or stock in a regulated investment company (a mutual fund or a closed-end investment company) to provide a retirement benefit for an employee can be excluded from the employee's income under the tax-sheltered annuity rules. Under proposed Treasury regulations, stock of a regulated investment company is considered purchased to provide a retirement benefit only if the stock cannot be distributed before the employee attains age 65 unless the employee dies or becomes disabled, and cannot be distributed on account of a separation from service unless the employee has attained age 55.

#### ***Reasons for change***

Although prior law restricted the favorable insurance company tax treatment of tax-sheltered annuities to retirement annuities, State law generally requires that the owner of an annuity contract be able to obtain the cash surrender value of the contract if the contract is surrendered before annuity payments begin. Consequently, an employee who owns a tax-sheltered annuity contract may be able to surrender the contract before retirement and use the proceeds for purposes other than retirement. The more restrictive rule for distribution of stock of a regulated investment company has imposed an undesirable competitive disadvantage on regulated investment companies.

#### ***Explanation of provision***

The Act permits distributions of stock of a regulated investment company after an employee dies, becomes disabled, separates from service, attains age 59½, or encounters financial hardship. Under the "financial hardship" rule, stock in a regulated investment company could be distributed to an employee if the hardship is such that it would permit a distribution from a qualified profit-sharing plan which provides for distributions in the event of financial hardship. The "financial hardship" rule for stock will permit distributions to an employee for the purpose of purchasing a residence or to provide higher education for the employee's children.

#### ***Effective date***

The provision applies for taxable years beginning after December 31, 1978.

#### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million annually.

#### **4. Pension Plan Reserves (sec. 155 of the Act and sec. 805(d) of the Code)**

##### ***Prior law***

Under prior and present law, favorable income tax treatment is accorded to a life insurance company with respect to the portion of its life insurance reserves allocable to annuity contracts entered into with trusts under tax-qualified pension plans. Under prior law, this favorable treatment did not apply to annuity contracts issued to State and local governments in connection with their unfunded deferred compensation plans or to annuity contracts issued to trusts under State and local retirement plans which were not tax-qualified.

##### ***Reasons for change***

Because State and local governments are tax-exempt, income on assets held by them and used to pay pension liabilities is not subject to tax. However, income on assets held in a life insurance company's reserves and allocable to nonqualified annuity contracts issued to State and local governments to pay pension liabilities is generally taxable. This puts insurance companies which offer annuity contracts at a competitive disadvantage when compared with sellers of other types of investments used by State and local governments for the purpose of paying pension benefits.

##### ***Explanation of provision***

Under the Act, the portion of a life insurance company's life insurance reserves which is allocable to annuity contracts entered into (1) with trusts under State or local nonqualified pension plans, or (2) with State or local governments for the purpose of paying pension benefits under unfunded plans which defer the compensation of participants to taxable years after it is earned, is accorded the same favorable tax treatment accorded reserves allocable to annuity contracts entered into under tax-qualified pension plans. The Act does not provide for the recomputation of the portion of a reserve allocable to such contracts for any prior year. The Congress expects that the tax benefit provided to insurance companies under the Act with respect to existing contracts will be passed on to contract owners, as has been the case under previous amendments to the rules under which life insurance companies are taxed.

##### ***Effective date***

The provision applies for taxable years beginning after December 31, 1978.

##### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million annually.

## **5. Rollover of Distributions From a Tax-Sheltered Annuity (sec. 156 of the Act and sec. 403(b)(8) of the Code)**

### ***Prior law***

The recipient of a "lump sum distribution" from a tax-qualified pension, profit-sharing, stock bonus, or annuity plan may defer tax on the receipt of such distribution by rolling over the proceeds (net of any employee contributions) within 60 days of receipt to an IRA (an individual retirement account, annuity, or bond), or to another employer-sponsored qualified retirement plan.

Under prior law, recipients of distributions under a tax-sheltered annuity (described in sec. 403(b)) purchased by an employer that was a tax-exempt charitable organization or a public school were not eligible to roll distributions over to an IRA. However, a participant in a tax-sheltered annuity plan could exchange his or her annuity contract for another annuity contract tax-free (sec. 1035 of the Code) regardless of the holding period of the contract or the period of participation in the plan.

### ***Reasons for change***

The Congress believed that teachers and other employees of tax-exempt organizations who are eligible to participate in tax-sheltered annuity plans should have the added flexibility of being able to receive a distribution of assets set aside for retirement purposes with one employer and to reinvest those assets in annuity contracts used by a subsequent employer to provide retirement benefits, or of being able to reinvest the proceeds in an individual retirement arrangement if such an arrangement appeared to be a better investment for retirement purposes or if subsequent reinvestment in a tax-sheltered annuity contract is not available.

### ***Explanation of provision***

Under the Act, the recipient of a lump sum distribution under a tax-sheltered annuity contract is eligible to completely or partially roll over the otherwise taxable portion of the distribution to an IRA or to another tax-sheltered annuity. Subsequently, the amount rolled over to the IRA, plus earnings, may be rolled over to another tax-sheltered annuity, but may not be rolled over to a tax-qualified pension plan.

It was not intended that the Act would affect the availability of the tax-free exchange provisions of sec. 1035 as they currently apply to the exchange of one tax-sheltered annuity contract for another.

### ***Effective date***

The provision applies to distributions or transfers made after December 31, 1978, in taxable years beginning after that date. It was intended that the provision apply to distributions or transfers made after December 31, 1977, in taxable years beginning after that date.

It is anticipated that the effective date will be considered by the Congress in connection with technical corrections of the 1978 Act.

***Revenue effect***

This provision will reduce budget receipts by less than \$5 million annually.

## **6. Individual Retirement Account Technical Changes (sec. 157 of the Act)<sup>1</sup>**

### **a. Extension of period for making individual retirement plan contributions (sec. 157(a) of the Act and secs. 219(c)(3) and 220(c)(4) of the Code)**

#### ***Prior law***

Prior law allowed an individual a deduction from gross income for certain contributions to an IRA (an individual retirement account, an individual retirement annuity, or a retirement bond) secs. 219 and 220). Under the Employee Retirement Income Security Act of 1974 (ERISA) the contributions for a particular taxable year, in order to be deductible, had to be made by the close of the year. The Tax Reform Act of 1976 extended the time for making deductible contributions and establishing an IRA for a year to 45 days after the close of the year.

#### ***Reasons for change***

The Congress concluded that it is reasonable to allow an individual to establish an IRA and to make contributions to that IRA up to the due date for filing the tax return for the year in question. This rule will allow greater flexibility in planning and will give individuals more time to obtain needed information. (Since IRA contribution limits are based on 15 percent of an individual's compensation includible in gross income, the individual will have to ascertain this amount before he can know his contribution limit.)

#### ***Explanation of provision***

The Act extends the date by which an individual can make deductible contributions to an IRA for a taxable year. Under the Act such contributions will be deductible for a year if they are made on account of that year and on or before the date prescribed by law for filing the individual's Federal income tax return for that year (including extensions). As under prior law, the individual will be permitted to establish an IRA on the same date on which he or she made the contribution, so the extension of the time for making a contribution to an IRA applies to the establishment of the IRA as well as to deductions.

#### ***Effective date***

The provision applies to taxable years beginning after December 31, 1977.

#### ***Revenue effect***

This provision will have a negligible effect on budget receipts.

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<sup>1</sup> These provisions were added to the Revenue Act of 1978 by a Senate floor amendment. The provisions were the subject of a separate bill, H.R. 13619, which was reported by the House Ways and Means Committee. The committee report for that bill is House Rep. No. 95-1739, 95th Cong., 2d Sess. (1978).

**b. Deduction of excess contributions in subsequent year for which there is an unused limitation (sec. 157(b) of the Act and new secs. 219(c)(5) and 220(c)(6) of the Code and sec. 4973(b)(2) of the Code)**

***Prior law***

An individual is allowed a deduction from gross income for certain contributions to an IRA (secs. 219 and 220). The maximum deduction allowable for a taxable year generally is the lesser of 15 percent of compensation includible in gross income or \$1,500. In the case of an individual who has a nonworking spouse, the maximum deduction allowable is the lesser of 15 percent of compensation includible in gross income or \$1,750 provided the individual shares the contribution equally with his or her spouse. An amount contributed which does not qualify as a rollover contribution and which is in excess of the maximum deduction allowable is an "excess contribution".

An excess contribution is subject to an annual 6 percent excise tax unless corrected. In order to correct an excess contribution, an individual must either (1) receive a distribution of the excess amount, or (2) contribute an amount in a future year which falls short of the maximum deduction allowable for that year, in which case the excess contribution is deemed to be corrected to the extent of the shortfall. However, under prior law, the deduction for the year did not include the amount of the shortfall.

***Reasons for change***

If an individual is entitled to contribute \$1,000 to an IRA in each of two years and does so, the individual is allowed a \$1,000 tax deduction for each of those two years, for a total deduction of \$2,000. However, under prior law, if the individual contributed \$1,500 in the first year, then corrected this mistake by contributing only \$500 in the second year (instead of the \$1,000 he was entitled to contribute), his total deduction was only \$1,500 (\$1,000 for year one and \$500 for year two). The Congress believed that this result was inappropriate. Therefore, the Act allows the individual a make-up deduction (of \$500 under the facts given above) for the year the excess contribution is corrected.

***Explanation of provision***

The Act allows an individual a deduction from gross income for a taxable year where he corrects a previous excess contribution to an IRA by contributing less than the maximum amount allowable as a deduction for the year. The maximum deduction allowed by the Act for a correcting an undercontribution is the amount of the previous excess contribution. For example, if an individual was entitled to make a contribution of \$1,000 for 1978 and 1979, an excess contribution of \$400 for 1978 could be corrected by making a contribution of only \$600 for 1979 (\$400 less than the individual's maximum permissible contribution) and the individual would be entitled to a \$1,000 deduction for 1978 and for 1979.

If the individual erroneously took a deduction in a previous year for any part of the excess contribution and the period for assessing a deficiency for the previous year has expired, the amount allowed as a deduction under the Act would be correspondingly reduced.

The Act provides a transitional rule with respect to amounts of excess contributions made up by undercontributions for years prior to 1978. The rule allows a one-time catchup deduction from gross income for those amounts for 1978 rather than requiring amended returns to be filed for each year of undercontribution. For example, if an individual entitled to make a \$1,500 contribution for 1978 had made an excess contribution of \$800 for 1976, and \$300 for 1977, he could correct both excess contributions (totaling \$1,100) by making only a \$400 contribution for 1978 and would be entitled to a \$1,500 deduction for that year.

#### ***Effective date***

The provision applies to taxable years beginning after December 31, 1975.

#### ***Revenue effect***

This provision will reduce budget receipts by \$20 million in fiscal year 1979, and by \$8 million per year thereafter.

**c. Additional period to rectify certain excess contributions (sec. 157(c) of the Act and sec. 408(d) of the Code)**

***Prior law***

A 6-percent excise tax is imposed annually on an excess contribution to an IRA. An excess contribution is a contribution which exceeds the maximum deductible contribution and which does not qualify as a rollover contribution. Under prior law, however, the 6-percent excise tax was not imposed on the excess contributed in a year if (1) such amount did not exceed the excess of \$1,500 (\$1,750 in the case of a spousal IRA) over the amount allowable as a deduction for the year, (2) such amount, and the earnings thereon, were withdrawn on or before the filing date for the individual's income tax return (including extensions) for the year, and (3) the individual did not take a deduction for such amount.

If the excess contributed for a year was withdrawn after the date for filing the individual's return, (1) it was subject to the 6-percent excise tax for each year for which the excess remained in the IRA, (2) it was subject to a 10-percent early distribution tax if the individual was not at least age 59½ or disabled, and (3) it was includible in the individual's gross income for the year it was withdrawn.

***Reasons for change***

Under prior law, an individual who made an excess contribution to an IRA and who failed to catch and correct the excess contribution by the due date for filing his tax return could not correct the situation by withdrawing the excess contribution without paying ordinary income tax on the amount of the withdrawal (even though he was not allowed to deduct the excess contribution when he put it into the IRA) and also had a 10-percent additional income tax for making an early withdrawal from the IRA unless the individual was at least 59½ years old or disabled.

The Congress concluded that these rules were overly harsh. Most excess contributions are inadvertent and may not be detected for a substantial period of time. While some individuals may be in a position to correct the excess contribution by making an undercontribution for a later year (as described in the previous section), this alternative is not open to those who have lost their eligibility for IRA participation (as, for example, those who have become active participants in qualified retirement plans).

***Explanation of provision***

The Act allows an individual who has made a total contribution for a year which does not exceed \$1,750 to an IRA, all or part of which is an excess contribution, and who does not correct the excess contribution prior to the due date for filing his or her tax return for the year, later to withdraw the excess contributed for the year without (1) incurring a 10-percent early distribution tax, and



(2) being required to include the amount withdrawn in gross income.<sup>1</sup> (In order to avoid administrative and computational problems, the taxpayer is not required to withdraw any earnings attributable to the excess contribution; if such earnings were withdrawn they would be subject to tax, as under prior law.) The provision applies only to the extent that a deduction was not allowed for the amount of the excess contribution withdrawn. (A deduction would be treated as not having been allowed if the taxpayer did not claim the deduction, or if IRS disallowed the deduction upon audit. If a deduction was claimed and allowed for a year for which the period of limitations has not expired, a taxpayer could come under these provisions by filing an amended return for the year for which the excess contribution was made.)

The Act provides a transitional rule for excess contributions to IRAs for taxable years beginning before January 1, 1978. For such excess contributions, the provisions of the Act would apply without regard to the \$1,750 limitation. Thus, an individual could withdraw all such excess contributions, regardless of amount, to the extent deductions were not previously allowed for the excess contributions.

The Act also allows an individual to withdraw an excess contribution (regardless of the amount) made with respect to a rollover contribution (including an attempted rollover contribution) in any case in which the excess contribution occurred because the individual making the contribution reasonably relied on erroneous information required to be supplied by the plan, trust, or institution making the distribution which was the subject of the rollover.

The Act applies to distributions from IRAs in taxable years beginning after December 31, 1975. Thus, under the Act, the IRS is to refund to taxpayers all penalties and income taxes based on distributions from IRAs after that date which correct previous excess contributions.

### ***Effective date***

The provision applies to distributions from IRAs in taxable years beginning after December 31, 1975.

### ***Revenue effect***

This provision will decrease budget receipts by less than \$5 million annually.

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<sup>1</sup> As under prior law, the 6-percent excess contribution tax would not apply to the year of withdrawal.

**d. Addition of requirement that premiums on individual retirement annuity contracts must be flexible (sec. 157(d) of the Act and sec. 408(b) of the Code)**

***Prior law***

An individual is allowed a deduction from gross income for certain contributions to an individual retirement annuity. To qualify as an individual retirement annuity, an annuity contract must meet certain statutory specifications (sec. 408(b)). Under prior law, a fixed premium contract (e.g., a contract which requires fixed payments over a fixed period of time) which met these specifications qualified as an individual retirement annuity.

***Reasons for change***

If an individual funded an IRA through a fixed premium contract, he had to continue to make the premium payments (or face substantial forfeitures under the contract) even though his circumstances changed so that all or a portion of the fixed premium payments became non-deductible. Ordinarily this would happen when the individual joined a qualified plan and thereby lost his eligibility for IRA participation. For this reason, the Congress concluded that the fixed premium contract is not appropriate for use as an IRA funding vehicle. Those who wish to fund their IRAs through insurance contracts may use the flexible premium contract.

***Explanation of provision***

The Act requires that an annuity contract provide for the flexible payment of premiums in order to qualify as an individual retirement annuity.

The Act provides a transitional rule under which the exchange before January 1, 1981, of any fixed premium individual retirement annuity issued on or before November 6, 1978, for a flexible premium annuity contract will, at the election of the individual, be treated as a nontaxable exchange. The exchange of annuity contracts is optional. An individual retirement annuity contract issued before November 7, 1978, will not fail to qualify merely because it provides for fixed premiums.

***Effective date***

The provision applies to contracts issued or exchanged after November 6, 1978.

***Revenue effect***

This provision will have a negligible effect on budget receipts.

**e. Clarification of dollar limit in the case of individual retirement annuities and retirement bonds (sec. 157(e) and secs. 408(b) and 409(a) of the Code)**

***Prior law***

The Employee Retirement Income Security Act of 1974 (ERISA) permitted individuals to make deductible contributions to IRAs in an amount equal to the lesser of 15 percent of compensation includible in gross income, or \$1,500. The Tax Reform Act of 1976 raised the dollar limitation for such contributions to \$1,750 when the individual has a nonworking spouse with whom he or she shares the contribution equally (spousal IRA). Certain provisions of the Code defining an individual retirement annuity and a retirement bond were not amended by the 1976 Act to reflect the change in the dollar limitation from \$1,500 to \$1,750 for spousal IRAs.

***Reasons for change***

This provision of the Act corrects a technical oversight in prior law.

***Explanation of provision***

The Act modifies the definitions of an individual retirement annuity and a retirement bond to make it clear that the maximum dollar limitation for deductible contributions to a spousal IRA is \$1,750.

***Effective date***

The provision applies to taxable years beginning after December 31, 1976.

***Revenue effect***

This provision will have no effect on budget receipts.

**f. Rollover of proceeds from sale of property (sec. 157(f) of the Act and sec. 402(a)(6) of the Code)**

***Prior law***

Under prior law, a participant in a qualified plan who received a lump sum distribution from the plan or a complete distribution upon termination of the plan could avoid current tax by making a rollover contribution to an IRA or to another qualified plan within 60 days after the date of the distribution. If the individual received property other than cash in the distribution, the actual assets received had to be contributed to the IRA or to the other qualified plan in order to qualify for tax-free rollover treatment. If the individual sold any asset received in the distribution and contributed the proceeds from the sale to an IRA or to a qualified plan as part of an attempted rollover contribution, the entire contribution failed to qualify as a rollover. Also, if the unsuccessful rollover was made to an IRA, the amount contributed was treated as an excess contribution. Accordingly, (1) a 6-percent excise tax was imposed for each year for which the excess contribution remained in the IRA, (2) the excess contribution and the earnings thereon were included in gross income when distributed from the IRA, and (3) the excess contribution and earnings thereon were subject to a 10-percent penalty tax if distributed before age 59½ (except in disability cases).

***Reasons for change***

The Congress concluded that the rules of prior law, requiring property received from a plan to be recontributed in kind in order to constitute a valid rollover, were needlessly restrictive. Hardship could result if the plan participant had difficulty finding a trustee who was willing to accept the property in kind. (Many institutional trustees are reluctant to manage certain kinds of property.)

***Explanation of provision***

The Act permits the recipient of a lump sum distribution from a qualified plan or a complete distribution upon termination of a qualified plan, which consists in whole or in part of property other than cash, to receive tax-free rollover treatment by contributing the proceeds from the *bona fide* sale of the property, rather than the property itself, to an IRA or to another qualified plan within 60 days from the date of the distribution.

For example, assume that on September 1, 1980, an individual receives a lump-sum distribution consisting of \$50,000 in cash and \$50,000 worth of Corporation A stock (valued as of September 1, 1978). Assume further that on September 30, 1980, the individual sells all of the stock for \$60,000. His maximum rollover contribution (to be completed within 60 days of the September 1, 1980 distribution date) would be \$110,000 (\$50,000 of cash, plus the \$60,000 proceeds received on the sale of the stock). If the individual made a full \$110,000

rollover, no gain would be recognized on the sale of the stock. (This is the same result which would have occurred if the property had been rolled over immediately before the sale).

The same rule would apply in the case of a loss on the sale of the stock. If, on September 30, 1980, the individual sold the Corporation A stock for \$40,000, then his maximum rollover contribution would be \$90,000, and if the rollover were completed within the 60-day rollover period, no loss would be recognized on the sale of the stock.

Generally, under prior law (and under the Act) where an employee received a distribution of property from a qualified plan, and this distribution is not rolled over, then the employee is required to treat the fair market value of the property as ordinary income, and the amount taken into income becomes the employee's basis in the property.<sup>1</sup> Gain or loss subsequently realized on the sale of the stock is generally treated as capital gain or loss.

These same principles apply where there is a partial rollover of the proceeds of the sale of property, except that it will generally be necessary to allocate the retained proceeds between the ordinary income and capital gains portion of the retained amount. For purposes of these rules, the amount of ordinary income is determined by multiplying the fair market value of the property on the date of distribution by a fraction, the numerator of which is the amount of proceeds retained, and the denominator of which is the total proceeds of the sale. The amount of capital gain or loss is determined by multiplying the difference between the fair market value of the property on the date of sale, and the fair market value on the date of distribution by this same fraction (retained proceeds over total proceeds).

In some cases, where the individual receives both cash and property, or several pieces of property, it will be necessary to determine the extent to which the individual has rolled over cash (or proceeds from the sale of one piece of property as opposed to another) and to what extent he has rolled over proceeds. The Act permits the individual to make an election in this regard (not later than the date for filing his tax return for the year in question) by filing a written designation with the IRS. Once made, this designation is irrevocable. If no designation is made, the rollover amount is to be allocated pro rata between the cash distribution received from the plan and the value of any property received (determined as of the date of the distribution).

Thus, in the case of a partial rollover involving proceeds from the sale of property, the rollover amount will be tax free (until it is distributed from the IRA, at which point it will be treated as ordinary income) and the retained portion will be taxed partly as ordinary income, and partly as capital gain or loss, in accordance with the computation outlined above.

For example, assume that on September 1, 1980, an individual employed by Corporation B receives a lump sum distribution consisting of \$50,000 in cash and \$50,000 worth of Corporation A stock (valued as

<sup>1</sup> There is a limited exception to this rule under certain circumstances where the employee receives a lump-distribution of stock in his employer. In this case, the employee is generally not required to include in gross income the unrealized appreciation in the value of the stock which occurred after the stock was contributed to the plan. Of course, when the stock is sold, the employee will recognize capital gain or loss.

of September 1, 1980). Assume further that on September 30, 1980, that individual sells all of the stock for its then fair market value of \$60,000. The maximum rollover contribution (to be completed within 60 days of the September 1, 1980, distribution date) would be \$110,000 (\$50,000 of cash, plus the \$60,000 of proceeds received on the sale of the stock). As discussed above, if the individual made a full \$110,000 rollover, no gain would be recognized on the sale of the stock. But, assume that the individual makes a rollover of only \$80,000. He now may designate irrevocably on his tax return for the year of the rollover the extent to which he has rolled over cash from the plan and the extent to which he has rolled over proceeds from the sale of the stock.<sup>2</sup> Assume the individual designates the rollover as \$30,000 of cash from the plan and \$50,000 of proceeds. He then will have retained \$20,000 (\$50,000—\$30,000) of cash from the plan and \$10,000 (\$60,000—\$50,000) of proceeds from the sale of the stock, and will be taxed as follows:

**Ordinary income:**

Cash .....	\$20, 000
Portion of value of stock included in distribution which is considered retained ( $\$10,000/\$60,000 \times \$50,000$ ) --	8, 333
Total amount of distribution retained .....	28, 333
Gain attributable to stock distributed the proceeds from which are considered retained ( $\$10,000/\$60,000 \times \$10,000$ ) .....	1, 667
Total amount retained .....	<u>\$30, 000</u>

All of the foregoing discussion assumes that the employee had made no contributions to the plan. If the employee had made contributions to the plan, the employee is permitted to designate (by the due date for filing his tax return) which portion of the lump-sum distribution was attributable to employee contributions, and which portion of the money and property distributed and not rolled over was attributable to employer contributions to the plan. If the employee fails to make this designation, (1) first, the ordinary income portion of the property received and not rolled over will, to the extent thereof, be treated as being attributable to the employee's contributions to the plan on a pro-rata basis, and (2) second, the remainder of the property not rolled over will be treated as being attributable to the rest of the employee's contributions on a pro-rata basis.

***Effective date***

The provision applies to qualifying rollover distributions completed after December 31, 1978, in taxable years ending after December 31, 1978.

***Revenue effect***

This provision will have a negligible effect on budget receipts.

<sup>2</sup> The property must actually be sold for such a designation to be available.

- g. Rollover contribution to individual retirement plan of distribution to spouse from qualified plan or annuity (sec. 157(g) of the Act, secs. 403(a)(4) and 408(d)(3), and new sec. 402(a)(7) of the Code)

***Prior law***

A participant in a qualified plan who receives a lump-sum distribution from the plan may avoid current tax by making a rollover contribution to an IRA or to another qualified plan within 60 days after the date of the distribution. However, under prior law, the recipient of a lump-sum distribution on account of the death of a plan participant was not eligible to engage in a tax-free rollover.

***Reasons for change***

The Congress concluded that a spouse should have the same IRA rollover privilege which would have been available to the plan participant had the participant survived. Accordingly, the Act permits the spouse of a plan participant to completely or partially roll over a lump-sum distribution received from a plan on account of the participant's death into an IRA.

***Explanation of provision***

Under the Act, if a married individual participating in a qualified plan dies and his or her spouse receives a distribution from the plan which qualifies as a lump-sum distribution, the spouse may, within 60 days of the date of the distribution, make a tax-free rollover contribution to an IRA of the assets distributed from the qualified plan.

***Effective date***

The provision applies to lump-sum distributions completed after December 31, 1978, in taxable years ending after such date.

***Revenue effect***

This provision will reduce budget receipts by less than \$5 million annually.

**h. Removal of certain restrictions on rollovers (sec. 157(h) of the Act, and secs. 402(a)(5)(D) and 408(d)(3) of the Code)**

***Prior law***

If an individual receives a lump sum distribution from a qualified plan or a complete distribution upon termination of a qualified plan, the individual may avoid current tax by making a rollover contribution of the amount of cash plus the property distributed (less any amount allocable to employee contributions) to an IRA or to another qualified plan. Under prior law, for a distribution to qualify as a lump sum distribution, the individual had to have been a participant in the qualified plan for five or more full taxable years before the taxable year of the distribution.

An individual is permitted to make a rollover contribution of a distribution from an IRA to another IRA without including the amount of the distribution in gross income, providing the rollover occurs within 60 days after the date of the distribution. Under prior law, an individual could engage in this type of rollover only one time during any three-year period.

***Reasons for change***

The Congress concluded that the restrictions on rollovers as outlined above are unnecessarily restrictive and could inhibit both portability and the opportunity of the plan participant to shift his or her investment medium, or to change IRA trustees, as circumstances warrant. Thus, the Act eliminates the 5-year requirement with respect to rollovers from qualified plans, as outlined above, and permits rollover contributions between IRAs once a year (instead of once every three years, as under prior law).

***Explanation of provision***

The Act removes the requirement that an individual must participate in the qualified plan from which he or she receives a lump sum distribution for 5 or more years in order to be eligible for a tax-free rollover of the distribution to an IRA or to another qualified plan. For individuals who received lump sum distributions in a taxable year beginning in 1978, but who could not engage in a tax-free rollover because of the five-year participation rule, the Act extends the time period for making such rollovers to December 31, 1978. The Act does not modify the 5-year requirement for 10-year averaging or capital gain treatment with respect to a lump-sum distribution.

The Act also reduces the 3-year limitation on rollovers between IRAs to once each year. An individual is allowed to make rollover contributions of amounts from one IRA to another once each year.

***Effective date***

The provision applies to taxable years beginning after December 31, 1977.

***Revenue effect***

This provision will have a negligible effect on budget receipts.



**i. Waiver of excise tax on certain accumulations in individual retirement accounts or annuities (sec. 157(i) of the Act, and new sec. 4974(c) of the Code)**

***Prior law***

An individual who has established an individual retirement account or an individual retirement annuity is required to begin receiving distributions of a certain minimum amount from the account or annuity not later than the end of the taxable year in which the individual reaches age 70½. If an individual fails to make a required minimum distribution, the individual is subject to an accumulation penalty tax equal to 50 percent of the amount which was required to be distributed, but was not distributed. Under prior law, the Secretary of the Treasury was not given the authority to waive this penalty tax.

***Reasons for change***

Prior law automatically imposed a flat 50 percent tax on excess accumulations in an IRA. There are circumstances where these accumulations (or underdistributions) may occur through no fault of the plan participant. The Congress concluded that the Internal Revenue Service should be allowed to waive the penalty tax where it is shown that the excess accumulation was due to reasonable error and that reasonable steps are being taken to correct the situation.

***Explanation of provision***

The Act gives the Secretary of the Treasury the power to waive the 50-percent accumulation penalty tax in circumstances where the individual subject to the tax establishes to the satisfaction of the Secretary that (1) the shortfall in the amount distributed was due to reasonable error, and (2) the individual is taking reasonable steps to remedy the shortfall.

***Effective date***

The provision applies to taxable years beginning after December 31, 1975.

***Revenue effect***

This provision will have a negligible effect on budget receipts.

**j. Removal of certain limitations on provision allowing correction of excess contributions (sec. 157(j) of the Act, and sec. 4973(b) of the Code)**

***Prior law***

A 6-percent excise tax is imposed on an excess contribution to an IRA. Under prior law, if for a taxable year an individual made an excess contribution to an IRA but withdrew the amount of the contribution, and any earnings thereon, on or before the date prescribed by law for filing his or her tax return for the year, the 6-percent excise tax was not imposed if (1) the excess contribution resulted either from employer contributions to a qualified plan, governmental plan, or tax-sheltered annuity, or from the failure of the individual to earn sufficient compensation for the year to make him eligible for the full amount of the contribution, and (2) the total amount withdrawn from the IRA did not exceed the excess of \$1,500 (\$1,750 in the case of a spousal IRA) over the amount allowable as a deduction for the year for a contribution to an IRA.

***Reasons for change***

Prior law permitted an individual to correct an excess contribution to an IRA by withdrawing that excess before the due date for filing his tax return, but imposed a dollar limitation which restricted the usefulness of this correction technique where the excess amount was made in connection with a rollover contribution. The Act corrects this situation by removing the dollar limitation. Under the Act, the full amount of the excess contribution, plus any earnings thereon, are includible in the gross income of the individual for the year for which the excess contribution was made.

***Explanation of provision***

Under the Act, the dollar limitation is removed. Thus, an individual who makes an excess contribution to an IRA, withdraws the full amount of the excess contributed, and any earnings thereon, on or before the date prescribed by law for filing the tax return for the year (including extensions) and does not take a deduction for the excess contribution, will be treated as not having made an excess contribution for the year. Accordingly, no 6-percent excise tax will be imposed for the year with respect to the excess contributed. The earnings on the excess contributed up to the date of withdrawal will be includible in the gross income of the individual for the year for which the excess contribution was made, but will not be subject to a 10-percent early distribution tax.

***Effective date***

The provision applies to contributions made for taxable years beginning after December 31, 1977.

***Revenue effect***

This provision will have a negligible effect on budget receipts.

**k. Simplification of return requirement with respect to individual retirement plans (sec. 157(k) of the Act, and sec. 6058 of the Code)**

***Prior law***

Under prior law, an individual who established an IRA was required to file a tax return with respect to the IRA for each year of its existence irrespective of whether, in any particular year, the individual contributed to the IRA, made withdrawals or received distributions from the IRA, engaged in a prohibited transaction with respect to the IRA, or incurred a penalty tax with respect to the IRA.

***Reasons for change***

The Congress concluded that a taxpayer should not be required to file a separate tax form in connection with the IRA for years where there is no activity other than making allowable contributions to, or receiving permissible distributions from, the IRA. Thus, the Act eliminates the separate filing requirement under these circumstances.

***Explanation of provision***

Under the Act, an individual does not have to file a tax return for an IRA for any taxable year (1) for which no penalty tax is imposed with respect to the IRA, and (2) for which no activity is engaged in with respect to the IRA other than making deductible contributions to, and permissible distributions from, the IRA. (Under the Act, separate reporting may still be required with respect to rollover contributions.) Information with respect to a deductible contribution or a permissible distribution will be included on the regular Form 1040. (Presently this information is reported both on the Form 1040 and on a separate form.)

***Effective date***

The provision applies to taxable years beginning after December 31, 1977.

***Revenue effect***

This provision will have no effect on budget receipts.

## F. OTHER INDIVIDUAL TAX PROVISIONS

### 1. Tax Treatment of Certain Government Scholarship and Award Programs (sec. 161 of the Act)

#### *Prior law*

##### *Uniformed Services Health Professions Scholarships*

Public Law 95-171 provides that participants in the Uniformed Services Health Professions Scholarship Programs (including the Armed Forces and Public Health Services programs) entering before 1979 may exclude from their income amounts received under those programs through 1982.

##### *National Research Service Awards*

In 1977, the Internal Revenue Service ruled (Rev. Rul. 77-319) that amounts received as National Research Service Awards under the Public Health Service Act of 1974 (42 U.S.C., sec. 2891(1)), which have no specific statutory exclusion, are not excludable scholarships or fellowship grants.

#### *Reasons for change*

In view of Congressional and Administration concern regarding the need for health professions scholarships for the Uniformed Services, the Congress believes that these scholarships should continue to be excluded from gross income pending a comprehensive review of the appropriate tax treatment of these grants as a part of the overall national policy toward the military and other uniformed service health professions programs. The Congress also believes that amounts received as National Research Service Awards should be accorded tax-exempt treatment pending further study.

#### *Explanation of provisions*

##### *Uniformed Services Health Professions Scholarships*

The Act extends the exclusion provided under prior law for participants in the Uniformed Services Health Professions Scholarship programs (including the Armed Forces and Public Health Professions Scholarship programs) so that students entering the programs in 1979 may exclude amounts received under these programs through 1983. This one-year extension generally will cover program participants entering medical school in 1979 for their four years of training.

##### *National Research Service Awards*

In addition, the Act provides tax-exempt scholarship treatment for National Research Service Awards made through 1979 for the duration of such awards.

***Effective date***

The provision extending the tax exemption for participants in the Uniformed Services Health Professions Scholarship programs is effective with respect to students entering programs in 1979, and applies to amounts received by them through 1983.

The tax-exempt scholarship treatment for National Research Service Awards applies to awards made during calendar years 1974 through 1979.

***Revenue effect***

The one-year extension of tax exemption for Uniformed Services Health Professions Scholarship programs will reduce budget receipts by less than \$5 million per year for fiscal years 1979–1983.

The tax exemption for National Research Service Awards will reduce budget receipts by \$52 million in fiscal year 1979 (which includes liabilities for prior years), \$18 million in fiscal year 1980, \$10 million in fiscal year 1981, and less than \$5 million in fiscal year 1982.

## **2. Cancellation of Certain Student Loans (sec. 162 of the Act and sec. 61 of the Code)**

### ***Prior law***

Under prior and present law, gross income means all income, from whatever source derived, including income from discharge of indebtedness, unless otherwise provided by law (sec. 61). However, subject to certain limitations, gross income does not include any amount received as a scholarship at an educational institution or as a fellowship grant (sec. 117(a)). An amount paid to an individual to enable him or her to pursue studies or research does not qualify as a scholarship or fellowship grant if such amount represents compensation for past, present, or future employment services or if such studies or research are primarily for the benefit of the grantor (Treas. regs. § 1.117-4(c)).

Under certain student loan programs established by the United States and by State and local governments, all or a portion of the loan indebtedness may be discharged if the student performs certain services for a period of time in certain geographical areas pursuant to conditions in the loan agreement. In 1973, the Internal Revenue Service ruled on a situation in which a State medical education loan scholarship program provided that portions of the loan indebtedness were discharged on the condition that the recipient practice medicine in a rural area of the State. The Service determined that amounts received from such a loan program were included in the gross income of the recipient to the extent that repayment of a portion of the loan is no longer required (Rev. Rul. 73-256, 1973-1 C.B. 56). On November 4, 1974, the Service determined that this ruling would be applied only to loans made after June 11, 1973, the date of the ruling explained above (Rev. Rul. 74-540, 1974-2 C.B. 38).

Section 2117 of the Tax Reform Act of 1976 (P.L. 94-455) provided that in the case of loans forgiven prior to January 1, 1979, no amount was to be included in gross income by reason of the discharge of all or part of the indebtedness of the individual under certain student loan programs. The exclusion applies to a discharge of indebtedness if the discharge was pursuant to a provision of the loan agreement under which all or part of the indebtedness would be discharged if the individual works for a certain period of time in certain professions in certain geographical areas or for certain classes of employers. The amendment made by the 1976 Act applies to student loans made to an individual to assist in attending an educational institution only if the loan was made by the United States or an instrumentality or agency thereof or by a State or local government either directly or pursuant to an agreement with an educational institution.

### ***Reasons for change***

Many States and cities have experienced difficulty in attracting doctors, nurses, and teachers to serve certain areas, including both rural communities and low-income urban areas. A provision in stu-

dent loan programs for loan cancellation in certain circumstances is intended to encourage the recipients, upon graduation, to perform needed services in such areas. In these circumstances, the loan cancellation is not primarily for the benefit of the grantor (as the Service ruled in 1973), but for the benefit of the entire community. The exclusion from income of the amount of indebtedness discharged in exchange for these services promotes the purpose of the programs.

### ***Explanation of provision***

The provision extends to loans forgiven prior to January 1, 1983, the exclusion from income provided by the Tax Reform Act of 1976 with respect to cancellation of certain student loans.<sup>1</sup> Accordingly, no amount will be included in gross income by reason of the discharge of all or part of a student loan of the type described in section 2117 of the 1976 Act if the loan is forgiven prior to January 1, 1983.

### ***Effective date***

The provision applies with respect to loans forgiven prior to January 1, 1983.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million per year for fiscal years 1979-1983.

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<sup>1</sup> This provision was added to the Revenue Act of 1978 by a Senate Finance Committee amendment. The provision had earlier been added by Senate floor amendment to a separate bill, H.R. 112, as passed by the Senate, with amendments, on August 23, 1978.

### **3. Tax Counseling for the Elderly (sec. 163 of the Act)**

#### ***Prior law***

Prior law provided a number of specific tax benefits for elderly or retired individuals; however, it contained no provision dealing with tax counseling for the elderly. The Internal Revenue Service has, however, established a Volunteer Income Tax Assistance (VITA) program which provides individual taxpayer assistance through the use of Internal Revenue Service-trained volunteers.

#### ***Reasons for change***

Preparation of a tax return is frequently a difficult task for the elderly. Upon reaching retirement age, taxpayers are often confronted with new provisions and complex forms. They often must complete a tax credit for the elderly schedule or a retirement income credit schedule, determine the taxable portion of retirement annuities, or compute the taxable gain when they sell their residences. For an untrained elderly individual, who has perhaps had no experience with the preparation of tax returns other than the short form 1040A, this change in circumstances may result in overpayment of tax. Alternatively, elderly taxpayers may have to rely upon expensive professional taxpayer services.

The Congress believed that these problems would be mitigated if the Internal Revenue Service were to expand substantially its tax counseling service particularly tailored to the needs of the elderly. The Congress believed that the needs of the elderly in this area are not being adequately met because of the limited scope of the VITA program. Accordingly, the Act authorizes the Internal Revenue Service to enter into arrangements with private or public nonprofit institutions pursuant to which the IRS will furnish the training and technical assistance necessary to enable these nonprofit institutions to establish tax counseling programs for the elderly.

#### ***Explanation of provision***

The Act authorizes the Secretary of the Treasury, through the Internal Revenue Service, to enter into training and technical assistance agreements with private or public nonprofit agencies and organizations to prepare volunteers to provide tax counseling assistance for elderly individuals in the preparation of their Federal income tax returns. An "elderly individual" is defined as a person who has reached the age of 60 as of the close of a taxable year.

Under the Act, the Service is authorized to provide reimbursement to volunteers for transportation, meals, and other expenses incurred by them in training or providing counseling assistance. The amounts received by the volunteers as reimbursement for these expenses are to be exempt from income and social security taxes, except to the extent that a charitable contribution or other deduction is claimed for these expenses. The Secretary is authorized to provide the volunteers with



preferential access to Internal Revenue Service taxpayer service representatives and make available technical information and material needed for their use.

Additionally, the Act provides that, from time to time, the IRS is to direct the attention of elderly individuals to tax measures of particular interest and application to the elderly, such as the tax credit for the elderly (under sec. 37 of the Code) and the provision reducing the tax on the capital gain on the sale of a residence for those age 55 and over (sec. 121 of the Code).

The Act authorizes to be appropriated to carry out the intent of this provision the amount of \$2.5 million for fiscal year 1979 and \$3.5 million for fiscal year 1980.

***Effective date***

This provision is effective on the date of enactment of the Act. (November 6, 1978).

***Revenue effect***

This provision will have a negligible effect on budget receipts.

#### **4. Employer Educational Assistance Programs (sec. 164 of the Act and new sec. 127 of the Code)**

##### ***Prior law***

Under prior law, there was no provision for a specific exclusion from an individual's income for educational assistance provided by an employer. Thus, a determination whether an individual was required to include in income money or benefits furnished to assist him in his education generally was governed by sections 61 and 117 of the Code.

Section 61 provides that, unless otherwise excluded by law, gross income means all income from whatever source derived including, but not limited to, compensation for services. Under section 117, subject to certain qualifications, amounts received as scholarships at educational institutions and amounts received as fellowship grants are excluded from gross income.<sup>1</sup> The exclusion also covers incidental amounts received to cover expenses for travel, research, clerical help, and equipment.

The exclusion for scholarships and fellowship grants is restricted to educational grants by relatively disinterested grantors who do not require any significant consideration from the recipient.<sup>2</sup>

Under present law (Treas. reg. § 1.162-5), educational expenditures made by an individual for his own education generally are deductible if they are for education that (1) maintains or improves skills required by the individual's employment or other trade or business, or (2) meets the express requirements of the individual's employer or the requirements of applicable law or regulations imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation. These types of education are commonly called "job-related education." However, no deduction is allowed for expenditures for education required of the individual in order to meet the minimum educational requirements for employment qualification in the individual's employment or other trade or business or for expenditures for education which is part of a program of study which will qualify the individual in a new trade or business. Such expenses may not be deducted even if the education maintains or improves skills required by the individual in the individual's employment or other trade or business or meets the express requirements of the individual's employer or applicable law or regulations. Nondeductible

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<sup>1</sup> To some extent, qualifications differ for individuals who are candidates for degrees and individuals who are not degree candidates. A degree candidate cannot exclude any amount to the extent it represents compensation for teaching, research, or other part-time services which the individual is required to render in order to obtain the grant unless such services are required of all candidates for a particular degree as a condition for receiving the degree.

In the case of a non-degree candidate, the exclusion is available only for up to \$300 per month for no more than 36 months and then only if the grantor of the scholarship is a qualified governmental unit, charity, or international organization.

<sup>2</sup> *Bingler v. Johnson*, 394 U.S. 741 (1969).

educational expenditures are personal expenses of the employee. Similarly, expenses which are incurred by an individual for recreation and which are not connected with a trade or business or the production of income, such as taking courses in connection with a hobby, are personal expenses of the individual and are not deductible. Thus, unless the educational expenses are deductible to the individual under the above rules, an employee ordinarily will have income which is not offset by deductions in the following situations:

- (1) the employee is reimbursed for educational expenses by the employer;
- (2) the employee's educational expenses are paid directly by the employer; or
- (3) the employer furnishes educational services directly to the employee.

An employer ordinarily can deduct amounts paid or incurred to provide educational assistance to employees because such amounts are treated as compensation under section 61.<sup>3</sup> However, such amounts may be nondeductible in some cases, for example, either as excessive compensation or as dividends, if the benefitted employees are shareholders.

Generally, unless specifically excluded by statute, all remuneration paid to employees, regardless of the form in which paid, constitutes wages subject to withholding of income and employment taxes. Remuneration is not necessarily excluded from the definition of employment tax wages for purposes of employment taxes and income tax withholding simply because it is excludible from gross income under the Code. However, Treasury regulations provide that certain advances and reimbursements paid to employees for ordinary and necessary business expenses are excluded from the definition of wages for withholding and employment tax purposes. Pursuant to these regulations, the Internal Revenue Service has ruled that educational expenses paid on behalf of, or reimbursed to, an employee for courses which maintain or improve skills required in employment, or meet express requirements of an employer as a condition to retaining employment, that is, job-related educational expenses, are excludable from the wages of the employee for purposes of employment taxes and income tax withholding. If the courses do not satisfy these tests, their cost has been considered a personal expense of the employee and the advance or reimbursement is includible in wages and subject to employment taxes and withholding.<sup>4</sup>

### ***Reasons for change***

The Congress believes that the treatment of employer-provided educational assistance under prior law occasionally gave rise to inequitable administration, added to the complexity of the tax system,

<sup>3</sup> In situations where an employer acquires items with a useful life in excess of one year and uses them for the direct furnishing of educational assistance to employees, the cost would have to be recovered through deductions for depreciation over the useful lives of such items. In other situations, the deductions would normally be allowed when the amount is paid or incurred (depending on the employer's method of accounting).

<sup>4</sup> See Treas. Reg. §§ 31.3121(a)-1(h), 31.3306(b)-1(h), and 31.3401(a)-1(b) (2); Rev. Ruls. 78-184, 1978-1 C.B. 304; 76-62, 1976-1 C.B. 12; 76-71, 1976-1 C.B. 308; and 76-352, 1976-2 C.B. 37.

and may have acted as a disincentive to continuing education, particularly among those at the lower end of the economic scale.

Because ambiguities exist in the "improve or maintain skills" test, the taxability of educational assistance programs of particular employers necessarily has depended on IRS agents' case-by-case analyses of the skills needed for the jobs held by each employee participating in such programs.

The "job-related" distinction often seems both ambiguous and restrictive. For example, if a person with little or no work experience is employed in an entry-level position and receives training from his employer to advance to a job requiring some greater skills or experience, the value of the training may be taxable. This may discourage self-improvement. If a typist, for example, receives training to be a secretary, or if a secretary receives training in a paralegal program, it might be considered not job-related. Also, if a clerical employee receives computer training, it may be treated as not job-related, even though the employee's job may require computer skills in the future because of normal advances in business technology.

The Congress believed it is important to reduce the complexity of the law in this area. Not only must the Internal Revenue Service use valuable personnel time in making determinations of taxability, but employees and employers also must justify their positions. The employer also must determine whether income tax withholding and employment taxes apply to reimbursement.

More serious than the potential inequities of administration and the complexities of the tax law is the disincentive to upward mobility. Although most citizens recognize the need to provide greater access to educational and economic opportunity to those who have had limited access in the past, the tax law has required out-of-pocket tax payments for employer-provided educational assistance from those least able to pay, even though they receive only services, not an increased paycheck.

Therefore, the Act provides an exclusion for employer-provided educational assistance. To avoid abuse of this expanded tax-free treatment of educational assistance, the Act limits the exclusion to benefits provided to employees and provides nondiscrimination rules.

### ***Explanation of provision***

#### ***General***

The Act excludes from an employee's gross income amounts paid for expenses incurred by the employer for educational assistance to the employee if such amounts are paid or such expenses are incurred pursuant to a program which meets certain requirements. In the case of education paid for, or furnished by, an individual's employer under such a program, the provision eliminates the need to distinguish job-related educational expenses from personal educational expenses for income tax purposes.<sup>5</sup>

#### ***Excludable benefits***

The educational benefits which may be excluded from income are those furnished by an employer only to employees. The types of educational assistance which may be furnished are not restricted.

<sup>5</sup> However, such a distinction still would have to be made in situations where the education is not excluded under this provision.

The employer may provide educational assistance to the employee directly or the employer may reimburse the employee for the latter's expenses. Under the Act, an employee can exclude from income tuition, fees, and similar payments, as well as the cost of books, supplies, and equipment paid for, or provided by, his employer; however, the employee cannot exclude tools or supplies which the employer provides and which the employee may retain after completion of the course of instruction. Meals, lodging, or transportation also may not be excluded under this section. There is no restriction as to who may furnish the educational assistance. Such assistance may be furnished by an educational institution or any other party. Also, the employer, alone or in conjunction with other employers, may furnish the education directly to the employees. The education which may be furnished is not limited to job-related courses nor to courses which are part of a degree program. However, the exclusion does not apply to educational assistance furnished for courses involving sports, games, or hobbies, except where the education provided involves the business of the employer.

For a program to qualify under this provision, the employees must not be able to choose taxable benefits in lieu of the educational benefits. In administering this rule, the business practices of an employer, as well as the written program, are to be taken into account.

A taxpayer may not claim any deduction, for example, a business expense deduction, nor may he claim any credit with respect to any amount which is excluded from his income under this provision. Thus, no double tax benefit may be obtained.

An employer educational assistance program is not required to be funded nor to be approved in advance by the Internal Revenue Service.

#### *Nondiscrimination requirements*

In order to be a qualified program, an educational assistance program also must meet requirements with respect to nondiscrimination in eligibility. The Act requires that a program must benefit employees who qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are officers, owners, highly compensated individuals, or their dependents. The program must be available to a broad class of employees rather than to a particular individual. However, employees may be excluded from a program if they are members of a collective bargaining unit and there is evidence that educational assistance benefits were the subject of good faith bargaining between the unit and the employer or employers offering the program.

The Act specifically provides that a program shall not be considered discriminatory merely because it is utilized to a greater degree by one class of employees than by another class or because successful completion of a course, or attaining a particular course grade, is required for, or considered in, determining reimbursement under the program.

Reasonable notification of the availability and terms of the program must be provided to eligible employees.

#### *Operation*

Under the Act, the exclusion does not apply if the program discriminates in favor of certain employees. A program is discriminatory if

more than 5 percent of the benefits can be paid to shareholders or owners (or their spouses or dependents), each of whom (on any day of the year) owns more than 5 percent of the stock or of the capital or profits interest in the employer.

### *Special rules*

An individual who qualifies as an employee within the definition of section 401(c)(1) of the Code also is an employee for purposes of these provisions. Thus, in general, the term "self-employed individual" means, and the term "employee" includes, individuals who have earned income for a taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for a taxable year.

An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer. A partnership is considered the employer of each partner who is also an employee of the partnership.

For determining stock ownership in corporations, this provision adopts the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). The Treasury Department is to issue regulations for determining ownership interests in unincorporated trades or businesses, such as partnerships or proprietorships, following the principles governing the attribution of stock ownership.

The Act also provides that amounts excluded from income as educational assistance are not to be treated as wages subject to withholding of Federal income tax nor as wages subject to employment taxes.

### *Effective date*

This provision applies to taxable years beginning after December 31, 1978, but does not apply to taxable years beginning after December 31, 1983.

### *Revenue effect*

This provision will reduce budget receipts by \$18 million in fiscal year 1979, \$28 million in fiscal year 1980, and \$39 million in fiscal year 1983.

## **TITLE II—TAX SHELTERS AND PARTNERSHIP PROVISIONS**

### **A. TAX SHELTER PROVISIONS: MODIFICATION OF AT RISK RULES (Secs. 201–204 of the Act and secs. 465 and 704(d) of the Code)**

#### ***Prior law***

The Tax Reform Act of 1976 contained two “at risk” rules dealing with tax shelters. These rules are designed to prevent a taxpayer from deducting losses in excess of his actual economic investment in the activity involved.

The first of these at risk rules—“the specific at risk rule”—applied to four specific activities: (1) farming; (2) exploring for, or exploiting, oil and natural gas resources; (3) holding, producing, or distributing motion picture films or video tapes; and (4) leasing of personal property (sec. 465). This specific at risk rule applied to all types of taxpayers other than regular corporations (that is, corporations which are not subchapter S corporations or personal holding companies).

Under the specific at risk rule, a taxpayer’s loss for any taxable year from covered activities is limited to the amount the taxpayer has placed at risk and could actually lose from this activity. Initially, the amount at risk is generally the sum of (1) the taxpayer’s cash contributions to the activity, (2) the adjusted basis of other property contributed to the activity, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability for repayment. Generally, this amount is increased by the taxpayer’s share of income and it is decreased by his share of losses and withdrawals from the activity.

The taxpayer is not generally considered at risk with respect to the proceeds (or his share of the proceeds) of a nonrecourse loan used directly or indirectly to finance his participation in the activity. Additional rules are provided to prevent avoidance of this rule by cross-collateralization of property involved in two different activities and borrowing from other participants in the same activity. Also, a taxpayer is not considered at risk to the extent his economic participation is protected from loss by guarantees, repurchase agreements, or insurance (except casualty insurance).

Losses which may not be deducted for any taxable year because of the specific at risk rule are deferred and may be deducted in any subsequent year in which this at risk limitation does not prevent the deduction.

The other at risk rule—“the partnership at risk rule”—applied generally to activities engaged in through partnerships. This rule (sec. 704(d)) provided that, for purposes of the limitation on allowance of partnership losses, the adjusted basis of a partner’s interest

did not include any portion of any partnership liability with respect to which the partner did not have any personal liability. However, there were two exceptions to this rule. First, the rule did not apply to any activity to the extent that the specific at risk rule (sec. 465) applied. Second, the rule did not apply to any partnership the principal activity of which was investing in real property (other than mineral property).

### ***Reasons for change***

The at risk rules of prior law imposed a significant limitation on many types of tax shelters. However, the rules did not cover three types of tax shelter situations. First, except in the case of the four types of activities specified in section 465, the at risk rules did not apply to direct investments. Second, the at risk rules did not apply to many types of closely held corporations which may use tax shelters. Third, the prior at risk provisions failed to adequately deal with situations where a taxpayer received distributions (or otherwise reduced his original at risk basis through debt guarantees, conversion of debt from recourse to nonrecourse, etc.) after having used his at risk basis to support losses in a prior year.

Except for the four activities to which the specific at risk rule applied, neither of the at risk rules applied to direct investments (i.e., investments made directly, not through partnerships). Essentially, the lack of any application of the at risk principles to direct investments constituted a major gap in the tax law in dealing with tax shelter abuses.

Thus, the Act provides a revised at risk rule which will apply to investments (direct or indirect) in all activities except real estate.

Under prior law, the at risk rule was applicable only to subchapter S corporations and personal holding companies, and not to other closely held corporations. Other closely held corporations were able to use tax shelter deductions to avoid the accumulated earnings tax or to shelter income on which owner-employees would otherwise pay tax at the individual level. To eliminate this type of income sheltering by these corporations, the Congress concluded that the at risk rules should be extended to closely held corporations, except those the primary activity of which involves equipment leasing.

Under a literal interpretation of prior law, subsequent withdrawals of amounts originally placed at risk (or changes in the status of such amounts so that they are no longer at risk) could have been made without the recapture of previously allowed losses. Since this circumvented the intent of the at risk limitation, the Act requires the recapture of previously allowed losses when the amount at risk is reduced below zero by withdrawals or changes in the status of amounts from at risk to not at risk.

### ***Explanation of provisions***

#### ***In general***

The Act revises the at risk rules by applying the specific activity at risk rule to all activities other than real estate. The partnership at risk rule is therefore repealed as redundant. The revised at risk rule also applies to corporations in which 5 or fewer individuals own more than



50 percent of the stock (except for certain situations involving equipment leasing). In the case of an affiliated group of corporations, the revised at risk rule is to apply to all corporations in the group if it applies to the common parent. Finally, the revised at risk rule requires a taxpayer to recapture losses previously claimed if he received distributions in excess of his at risk basis or if the amount which had previously been at risk is reduced below zero by the conversion of recourse debt to nonrecourse debt, by the commencement of a guarantee, or by similar changes in the amount of a taxpayer's at risk basis.

*Extending the at risk rule to all activities other than real estate*

*In general.*—The Act extends the specific at risk rule to all activities except real estate and repeals the partnership at risk rule. For the newly covered activities, the specific at risk rule covers activities which are engaged in either a trade or business (or a part thereof) or for the production of income.

*Aggregation of activities.*—The Act provides separate rules for aggregation and separation of the activities to which the at risk rule is extended by the Act. In general, it is provided that, with respect to these newly covered activities, those activities conducted by taxpayers other than partnerships and subchapter S corporations and which together constitute a trade or business shall be treated as one activity if the taxpayer actively participates in the management of the trade or business; the same treatment would apply in those cases where the trade or business is carried on by a partnership or subchapter S corporation and 65 percent or more of the losses from the taxable year is allocable to persons who actively participate in the management of the trade or business.

The determination of whether a person actively participates in the operation or management of a trade or business depends upon the facts and circumstances. Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the trade or business, actually performing services for the trade or business, or hiring and discharging employees (as compared to only the person who is the manager of the trade or business). Factors which tend to indicate a lack of active participation include lack of involvement in management and operation of the trade or business, having authority only to discharge the manager of the trade or business, or having a manager of the trade or business who is an independent contractor rather than an employee.

Furthermore, the Internal Revenue Service is given specific authority to prescribe regulations under which the activities which are made subject to the at risk limitation by the Act are to be aggregated or treated as separate activities. Thus, the regulations might provide for the aggregation of certain related activities which together do not necessarily constitute a trade or business, particularly where the activities involved do not have significant tax shelter potential. On the other hand, if one or more of the activities have tax shelter characteristics, the regulations may require separate activity treatment for one or more activities which constitute a single trade or business and which, under the rules described in the preceding paragraphs, would qualify for aggregation. Tax shelter characteristics which may be taken into

account in the regulations include the presence of accelerated deductions, mismatching of income and deductions, substantial nonrecourse financing, novel financing techniques which do not conform to standard commercial practices, property whose value is subject to substantial uncertainty, and the marketing of the activity to prospective investors as a tax shelter. In the absence of regulations permitting or requiring aggregation, it is anticipated that each investment which is not part of a trade or business will be treated as a separate activity, and separate investments will not be aggregated.

*Exclusion for real property.*—In the case of activities to which the Act extends application of the at risk rule, the holding of real property (other than mineral property) is to be treated as a separate activity,<sup>1</sup> and the at risk rule is not to apply to losses from this activity.<sup>2</sup> For purposes of this exclusion, personal property and services which are incidental to making real property available as living accommodations shall be treated as part of the activity of holding such real property. For example, this exception is intended to exclude from application of the at risk rule situations where a taxpayer owns and operates a hotel or motel. In such instances, the making available of personal property such as furniture and services in conjunction with the renting of the hotel or motel room are to be considered incidental to making real property available as living accommodations. Similarly, providing personal property and services in renting a furnished apartment are to be considered incidental to making real property available as living accommodations.

In situations where a trade or business involves both the holding of real property (other than mineral property) and the provision of personal property and services which are not incidental to making real property available as living accommodations, the holding of the real property will be treated as a separate activity which is not subject to the at risk rule; the remainder of the trade or business will be treated as a separate activity (or separate activities) to which the at risk rule would apply.<sup>3</sup> In these situations, an allocation of the receipts, income, deductions, and basis of the activities would be made. The allocation of income to the real property would equal that amount of income which bears the same ratio to the total amount of income

<sup>1</sup> It is contemplated, however, that in certain instances the Internal Revenue Service, pursuant to its authority to do so, will prescribe regulations providing for permissible aggregation of other activities with a real estate activity if the other activities do not have significant tax shelter characteristics, such as nonrecourse financing.

<sup>2</sup> If a partnership ("investing partnership") is a partner in another partnership ("primary partnership") and the primary partnership is engaged in a real estate activity which is not subject to the at risk rules, the partners of the investing partnership would not be subject to the at risk rule with respect to its activity of investing in the primary partnership to the extent that such investment is attributable to the real estate activity.

<sup>3</sup> In the case of a nursing home or old age home, the health care and meals provided would not be considered part of the real estate activity. Providing health care and food services are not incidental to making real property available as living accommodations. Consequently, a separation of the real property activity and the health care and meals activity (or activities) would be required.

as the real property related deductions bear to the total deductions.<sup>4</sup> For this purpose, deductions for administrative expenses or general overhead relating to real estate and other activities are to be reasonably allocated.

As an alternative to the method of allocation described above, if the fair rental value of the real property can be clearly established, taxpayers may elect to treat the fair rental value of the real property involved as the amount of income allocable to that property.<sup>5</sup>

The Act does not change the treatment provided under the Tax Reform Act of 1976 with respect to real estate used in one of the specified activities covered by the 1976 Act provisions (farming, oil and gas activities, motion pictures, or leasing of personal property). This real estate would be treated as part of the activity, rather than as a separate activity. Thus, for example, real property used in farming would be considered a part of the farming activity subject to the at risk rules.

*Loans from related and interested parties.*—The Tax Reform Act of 1976 (sec. 465(b)(3)) specifically requires that a taxpayer not be considered at risk with respect to amounts borrowed for use in an activity (or which are contributed to the activity) if the amounts are borrowed from any person who has an interest in the activity (other than that as a creditor) or who is related to the taxpayer (as described in sec. 267(b)). (Loans by governmental bodies which do not have any present or optional equity interest in the activity are not subject to this rule.) Although this rule continues to apply to the four specified activities, the Act provides that it is not to apply to the activities which are newly made subject to the at risk provision by the Act, except to the extent provided in regulations prescribed by the Treasury. The regulations may make this provision applicable to activities involving tax shelter characteristics, such as the presence of property the value of which is subject to substantial uncertainty, activities of a speculative nature, the unavailability of similar financing on similar terms from unrelated, commercial lenders, and the presence of terms or conditions under which either the loan becomes nonrecourse in later taxable years or the taxpayer can convert the obligation from a recourse obligation to a nonrecourse (or guaranteed) obligation in later years.

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<sup>4</sup> For example, assume that an individual owns and operates a restaurant and the individual incurs a loss of \$100,000 which is determined as follows: \$500,000 gross receipts, \$400,000 cost of goods sold, \$50,000 restaurant expenses (including depreciation on restaurant personal property) and \$150,000 for real estate taxes, depreciation on the structure, repairs and maintenance to the structure, and interest on the mortgage secured by the real property. In this instance, \$125,000 of the gross receipts would be allocated to the real property, computed as follows:

\$150,000 real property expenses divided by \$600,000 total expenses multiplied by \$500,000 income equals \$125,000.

Consequently, the real property activity would be treated as having incurred a loss of \$25,000 (\$125,000-\$150,000) and the restaurant activity a loss of \$75,000 (\$375,000-\$450,000). Only the restaurant activity loss would be subject to the at risk limitation.

<sup>5</sup> Thus, if in the example set forth under footnote 4, the taxpayer could establish that the annual fair rental value of the land and structure involved was \$100,000, that amount (as opposed to the \$125,000 derived under the allocation formula) would be treated as the receipts allocable to the real property.

*Repeal of partnership at risk rules.*—Since all the activities previously covered by the partnership at risk rules are now covered by the new expanded version of the specific at risk rules under section 465, the partnership at risk rules of section 704(d) are repealed, effective for taxable years beginning after December 31, 1978.<sup>6</sup> The Act provides that any losses which have been disallowed for a taxable year pursuant to the partnership at risk rules of section 704(d) will be treated as if they had been disallowed by the specific at risk rule of section 465 and, as a consequence, will be treated as a deduction in the first taxable year beginning after December 31, 1978.

However, the Act continues a transitional rule in the 1976 Act. Under this transitional rule, the at risk rule is not to apply to partnership liabilities which were not subject to section 704(d) (as in effect before the date of the enactment of this Act) by reason of section 213 (f) (2) of the Tax Reform Act of 1976.

*Extension of at risk rules to closely held corporations*

*In general.*—Under prior law, the only corporations to which the specific at risk rule applied were subchapter S corporations and personal holding companies. The Act extends the application of this rule to all corporations in which five or fewer individuals own more than 50 percent of the stock at any time during the last half of the taxable year.<sup>7</sup>

A determination of whether the stock ownership test is satisfied is generally made by reference to the stock ownership rule for personal holding companies under section 542(a) (2). Thus, a corporation will be subject to the at risk rule if, at any time during the last half of the taxable year, more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. The term “individuals” includes estates and trusts. (See sec. 641(b).) Moreover, in applying this stock ownership rule, a pension trust, a supplemental employment benefit trust (sec. 501(c) (17)), a charitable organization (described in sec. 509(a)), or a portion of a trust permanently set aside or to be used exclusively for charitable purposes (described in sec. 642(c)) shall be considered an individual. However, in determining whether 5 or fewer individuals own more than 50 percent of the stock of a corporation, the attribution rules of section 318, not section 544, are to apply.

If a corporation meets these ownership requirements, it will be subject to the at risk rules even if it does not meet other definitional requirements of a personal holding company (see sec. 542(a) (1)) or because it is excepted from personal holding company status (by sec. 542(c)).

*Exception for certain equipment leasing activities.*—Under the Act, the at risk rule does not apply to closely held corporations (i.e., where

<sup>6</sup> The partnership at risk rule of prior law applied to corporate partners in a partnership which was engaged in activities which were neither subject to the provisions of the specific at risk rule nor involve real property (other than mineral property). Consequently, the repeal of the partnership at risk rule (even with the extension of the specific at risk rule to certain closely-held corporations) results in the elimination of the applicability of the at risk rule to more widely held corporations.

<sup>7</sup> The provision continues to apply to all subchapter S corporations.

five or fewer individuals own more than 50 percent in value of the stock of the corporation), other than subchapter S corporations, to the extent they are actively engaged in leasing equipment which is section 1245 property. A closely held corporation will not be considered to be actively engaged in equipment leasing unless 50 percent or more of its gross receipts for the taxable year are attributable to equipment leasing. For purposes of this test, gross receipts include gross receipts from the sale or the servicing of the same type of equipment leased by the corporation.<sup>8</sup> "Equipment leasing" includes the leasing of such tangible personal property as computers,<sup>9</sup> copiers, calculators, airplanes, automobiles, tractors, cranes, railroad cars, and furniture. "Equipment leasing" does not include the leasing of master recordings and other similar contractual arrangements made with respect to tangible or intangible assets associated with literary, artistic, or musical properties (such as books, lithographs of works of art, or musical tapes). Equipment leasing also does not include any lease activity which is described in section 465(c)(1)(A), (B), or (D) (relating to motion picture films or video tapes, farming, and oil and gas property). Thus, for example, the lease of a video tape (which is described in section 465(c)(1)(A)) is not considered to be equipment leasing.

Losses attributable to an equipment leasing activity, which were suspended as a result of the application of the at risk rule, are to become fully deductible for the first taxable year in which the corporation meets the 50 percent or more gross receipts requirement. For the first taxable year in which a corporation fails to meet the 50 percent or more gross receipts requirement, the at risk basis in the equipment leasing activity is to be computed in accordance with the rules (including transitional rules<sup>10</sup>) normally applicable to computing at risk basis for the first year that an activity is subject to the at risk rule.

#### *Recapture of losses where amount at risk is less than zero*

Under a literal interpretation of prior law, the at risk rules may have only required the taxpayer to be at risk at the end of the taxable year for which losses are claimed. Thus, arguably, subsequent withdrawals of amounts originally placed at risk may have been made without the recapture of previously allowed losses. However, in order to be consistent with the original intent of the at risk rules, the Act requires the recapture of previously allowed losses when the amount at risk is reduced below zero. This recapture rule only applies to losses which are allowed (and reduce the taxpayer's at risk basis in the activity involved) for taxable years beginning after December 31, 1978.

<sup>8</sup> For example, the gross receipts from the sale and servicing of computers would be included if the corporation also leased computers, notwithstanding that the computers involved had different functional capacities. The gross receipts from the sale, servicing, and lease of office equipment would be combined for purposes of this test, as would the gross receipts from the sale, servicing, and lease of automobiles.

<sup>9</sup> For the purposes of this provision, computer software is to be considered equipment.

<sup>10</sup> Thus, amounts paid or incurred with respect to the equipment leasing activity for taxable years beginning prior to the year of disqualification, and deducted in such taxable years, will, generally be treated as reducing first that portion of the taxpayer's basis which is attributable to amounts not at risk. On the other hand, withdrawals made in taxable years beginning before the year of disqualification will be treated as reducing the amount which the taxpayer is at risk.

Mechanically, this rule works by providing that, if the amount at risk is reduced below zero (by distributions to the taxpayer, by changes in the status of indebtedness from recourse to nonrecourse, by the commencement of a guarantee or other similar arrangement which affects the taxpayer's risk of loss, or otherwise), the taxpayer will recognize income to the extent that his at risk basis is reduced below zero. However, the amount recaptured is limited to the excess of the post-December 31, 1978, losses previously allowed in that activity (which reduced the taxpayer's at risk basis in the activity) over any amounts previously recaptured.

The types of events which can result in the at risk basis being reduced below zero include distributions to the taxpayer, changes in the amount of recourse indebtedness attributable to the taxpayer, or the commencement of guarantees or similar arrangements which would reduce the taxpayer's amount at risk; losses cannot result in the at risk basis being reduced below zero (since the deduction of losses is allowed only to the point where the at risk basis is zero and further deduction of losses is suspended under the at risk rules). The effect of this recapture rule is to treat the reduction below zero in the amount at risk as if it had preceded the deductions which had been used to offset the original at risk amount. Consequently, a suspended deduction in the amount equal to the amount of income would be provided to the taxpayer. This suspended deduction would be allowed in a subsequent year if and to the extent the taxpayer's at risk basis is increased. A transitional rule provides that if the amount which the taxpayer is at risk in an activity as of the close of the taxpayer's last taxable year beginning before January 1, 1979, is less than zero, the provision is applied as if this negative at risk amount were zero and only further decreases in the at risk basis would be required to be included in income.

### ***Effective date***

The amendments made to the at risk rule generally apply to taxable years beginning after December 31, 1978. Thus, activities and transactions entered into prior to such taxable years may be subject to the expanded at risk rule even though they were not subject to section 465 as in effect prior to taxable years beginning after December 31, 1978.

However, with respect to leasing activities conducted by a closely held corporation which are subject to the at risk rule, the at risk rule will not apply to any type of leasing transaction where the property was either leased or ordered (by the lessor or lessee) before November 1, 1978, but only for those taxpayers who owned their interests in the property on October 31, 1978. For purposes of these transitional rules, an order, a lease, and the acquisition of an interest in the property will not be considered to have occurred until they are evidenced by binding and legally enforceable agreements which are complete as to all relevant terms. However, a lease agreement will be considered binding on the relevant dates under the above provisions even though it is later modified to increase (but not decrease) the lease term.

In addition, the loss recapture provision applies only to losses which were allowed and reduced the taxpayer's at risk basis in the activity involved for taxable years beginning after December 31, 1978.

In applying the at risk provisions to activities which were not subject to the at risk rule in taxable years beginning before January 1,

1979 (and not exempted from the at risk provision by transitional rules in this Act or the 1976 Act), amounts paid or incurred in taxable years beginning prior to that date and deducted in such taxable years will generally be treated as first reducing that portion of the taxpayer's basis which is attributable to amounts not at risk. On the other hand, withdrawals made in taxable years beginning before January 1, 1979, will be treated as reducing the amount which the taxpayer is at risk.

***Revenue effect***

It is estimated that these provisions will increase budget receipts by \$2 million in fiscal year 1979, \$13 million in 1980, and \$5 million in fiscal year 1983.

## B. PARTNERSHIP PROVISIONS

(Secs. 211 and 212 of the Act and secs. 6501, 6511, and 6998 of the Code)

### *Prior law*

For income tax purposes, partnerships are not taxable entities. Instead, a partnership is a conduit, in which the items of partnership income, deduction, and credit are allocated among the partners for inclusion in their respective income tax returns.

Partnerships are required to file an annual information return setting forth the partnership income, deductions, and credits, names and addresses of the partners, each partner's distributive share of these items, and certain other information required by the regulations. Neither the partnership nor any partner was subject to a civil penalty for failure to file, or for late filing of, a partnership information return.

Since a partnership is a conduit rather than a taxable entity, adjustments in tax liability may not be made at the partnership level. Rather, adjustments are made to each partner's income tax return at the time that return is audited. A settlement agreed to by one partner with the Internal Revenue Service is not binding on any other partner or on the Service in dealing with other partners. Similarly, a judicial determination of an issue relating to a partnership item generally is conclusive only as to those partners who are parties to the proceeding.

The Code provides a period of limitations during which the IRS can assess a tax or a taxpayer may file a claim for refund. Generally, the period is 3 years from the date the tax return is filed (if filed before the due date, the due date is treated as the date filed). If more than 25 percent of the gross income is omitted from a return, the statutory period for assessment is 6 years. In the case of a partnership, the income tax return of each of the partners began that individual partner's period of limitations. The date of filing of the partnership return did not affect the individual partner's period of limitations. In order to extend the period of limitations with respect to partnership items, the IRS was required to obtain a consent for extension of the statute of limitations from each of the partners—not the partnership. Generally, an agreement to extend the period of limitations related to all items on the returns of the partner who consented to the extension.

### *Reasons for change*

The number of large partnerships, particularly those with tiered ownership structures, increased dramatically in recent years. Many of these new large partnerships are complex tax shelter arrangements. In these arrangements, it is often difficult to identify the taxpayers who may ultimately be affected by an adjustment to a partnership item. The entity, for example, may be composed of several tiers, the partners being trusts, corporations, individuals, and other partnerships.

The IRS has identified instances in which large complex partnerships have not filed the annual partnership information return or, if



filed, the return does not contain the information necessary to identify the ultimate taxpaying partners. Consequently, the IRS has been forced to spend considerable time and resources attempting to determine who the partners are and whether they have reported their distributive shares of partnership items.

If the audit of the partnership return is expected to take a considerable length of time, as it often does in the case of the large complex tax shelter arrangements, the IRS has attempted to obtain waivers of the statute of limitations from each partner or other taxpayer who may be affected by the audit. Obtaining these waivers has been complicated, not only by the fact that it was difficult to identify these taxpayers, but also by the fact that in many cases the partners were widely dispersed geographically.

The Congress believed that the IRS would be better able to cope with auditing these large partnerships if it had complete and timely-filed return information with which to work. The Congress believed that the period of limitations in the case of large partnerships should not commence until a partnership return identifying the partners was properly filed. In addition, the Congress believed that in these situations the period of limitations with respect to partnership items should be extended for an additional year.

### ***Explanation of provisions***

#### ***Penalty for failure to file partnership return***

The Act adds a new provision (section 6698 of the Code) that imposes a penalty on the partnership for failure to timely file a complete partnership information return as required by existing Code sections 6031 (relating to the information to be included in a partnership return) and 6072 (relating to the time for filing the partnership return). The penalty is in addition to the criminal penalties imposed by Code section 7203 for willful failure to file a return, supply information, or pay a tax.

The penalty is assessed for each month, or fraction of a month (but not to exceed 5 months), that the partnership return is late or incomplete. The amount of penalty for each month, or fraction of a month, is \$50 multiplied by the total number of partners in the partnership during the partnership's taxable year for which the return is due. The penalty is assessed against the partnership. Partners are to be individually liable for the penalty to the extent of their liability for partnership debts generally.

The penalty will not be imposed if the partnership can show that failure to file a complete or timely return is due to reasonable cause. With respect to "small" general partnerships (those with 10 or fewer individual partners), it is anticipated that the reasonable cause requirement will be satisfied if each of the partners has fully reported all partnership items on his or her individual return.

The assessment of the penalty is not subject to the deficiency procedures of the Code. Thus, the partnership may not contest the assessment of the penalty in the United States Tax Court, but rather must pay the entire penalty and sue for refund in the U.S. District Court or Court of Claims.

The penalty only applies where a partnership return is required to be filed. Thus, an unincorporated organization which has properly

elected (under section 761(a)) not to be treated as a partnership is not subject to these penalties since no partnership return is required to be filed by that organization.<sup>1</sup>

*Extension of statute of limitations*

The Act amends Code sections 6501 and 6511 to extend the period of time in which assessments of deficiencies and claims for refund of tax attributable to "partnership items" may be made. These special periods of limitation apply only to partnership items that are attributable to "federally registered partnerships" (as discussed below).

With respect to deficiencies, the Act provides generally that the Service may assess a deficiency attributable to partnership items within 4 years after the partnership return for the partnership taxable year in which the item arose is filed. If the partnership return does not properly show the name and address of the person to be assessed the deficiency, the period of assessment will not expire until 1 year after that information is provided to the Service in the manner prescribed by regulations. In the case of partnership tiering arrangements, it is anticipated that the regulations will provide that this notification requirement is satisfied as to any taxpayer if each "pass through" entity within the tiering arrangement (e.g., partnerships, trusts, nominees, and subchapter S corporations) through which he traces his claim of ownership properly discloses the name, address and taxpayer identification number of their respective owners.<sup>2</sup> If the partnership return is filed before the date prescribed by law for filing the return (determined without regard to extensions), the date filed will be considered the due date.

Any general partner of the partnership in which the partnership item arose, or any other person authorized by the partnership in writing, may consent to extend the 4-year period of limitation for all partners. The partnership may restrict the authority of any (or all) general partner(s) to execute such a consent by notifying the Secretary of the Treasury in writing in the manner prescribed by regulations.

With respect to credits and refunds, the Act provides generally that the taxpayer may file a claim for credit or refund of tax attributable to partnership items within 4 years after the due date (including extensions) of the partnership return for the partnership taxable

<sup>1</sup> This rule applies to an election made under either subdivision (i) or (ii) of Treasury Regulation § 1.761-2(b) (2), relating to the method of electing not to be treated as a partnership.

<sup>2</sup> For example, assume a partnership tiering arrangement that consists of Partnership A (the first tier partnership) that has as partners Partnership B, a simple trust and a subchapter S corporation. Partnership B has as partners Partnership C and a regular corporation. Assume further that Partnership A properly discloses the identity of its three partners; Partnership B does not disclose the identity of any of its partners; Partnership C discloses the identity of its partners and the trust and the subchapter S corporation properly disclose their beneficiaries and stockholders, respectively. In this instance, the partners of Partnership C and the regular corporation will not have satisfied the notification requirement because the reporting of their chain of ownership to Partnership A (the partnership in which the partnership item arose) is broken at Partnership B. On the other hand, the beneficiaries of the trust and shareholders of the subchapter S corporation will have satisfied the notification requirement because the reporting of their line of ownership to Partnership A is unbroken.

year in which the item arose. If the taxpayer, or a general partner or a person authorized by the partnership, has entered into an agreement with the IRS to extend the period of time for assessing a deficiency attributable to partnership items, a claim for credit or refund of tax attributable to partnership items may be filed within 6 months after the expiration of the extension of time for assessment.

If a taxpayer incurs a net operating loss for a taxable year, the portion of the loss that is attributable to a partnership item may be carried back on a claim for refund filed at any time up to 4 years following the due date of the partnership return for the partnership taxable year in which the item arose.

These special periods of limitation for assessments or claims for refund of taxes attributable to partnership items are in addition to, and not a replacement of, the periods of limitations provided in present laws.<sup>3</sup>

Similarly, if a claim for credit or refund for any item on a return, including partnership items, could be filed under present law rules at a time later than that which is provided by the special rules for partnership items, the special rules do not preclude the filing of the claim.

#### *Federally registered partnership*

The special period of limitations applies only to partnership items flowing from "federally registered partnerships." A federally registered partnership means any partnership the interests in which have been offered for sale prior to the close of the taxable year in an offering required to be registered with the Securities and Exchange Commission, or any partnership which is or has been subject to the annual reporting requirements of the Securities and Exchange Commission relating to protection of investors in the partnership. For example, the reports required to be filed with the SEC by a brokerage firm or an accounting firm organized as partnerships for regulatory purposes do not cause these firms to be treated as Federally registered partnerships. A partnership may not avoid the extension of the period of limitations by failing to register or report as required by the SEC. If a partnership is excused from registration or reporting by either a statutory or a regulatory exemption of the SEC, it is not to be treated as a Federally registered partnership.

#### *Partnership item*

With respect to any taxpayer, a partnership item is attributable to a federally registered partnership if it arose in a federally registered partnership or is taken into account by the taxpayer by reason of a chain of ownership that includes a federally registered partnership.

In determining whether an item is a partnership item, two tests are applied. First, the item must be one that is required to be taken into account by the taxpayer, or any other entity in which the taxpayer has

<sup>3</sup> Thus, for example, if a partnership with a taxable year ending January 31, 1980 files its return by the May 15, 1980 due date, these special rules provide that the Service may assess deficiencies with respect to partnership items through May 15, 1984. However, if a partner of that partnership files his calendar year 1980 income tax return (which is the return in which he would report these partnership items) by an extended due date of June 15, 1981, the IRS may assess deficiencies attributable to any item in his return, including partnership items, through June 15, 1984 under present law period of limitation rules.

a direct or indirect interest, under any provision of the partnership provisions (subchapter K of chapter 1 of the Code). Second, the Secretary of the Treasury must prescribe by regulation that the item is more appropriately determined at the partnership level than at the partner level. If either of these tests is not met, the item is not a partnership item. In addition, other items are partnership items to the extent they are affected by a partnership item.<sup>4</sup>

An item is considered required to be taken into account under subchapter K if, under any reasonable characterization of the item, it may affect the basis in partnership property, the distributive share or the basis in the partnership interest of any two or more partners, one of whom is the taxpayer.<sup>5</sup>

### *Effective date*

The penalty provision of the Act is effective for returns for taxable years beginning after December 31, 1978.

The statute of limitation provision of the Act is effective for items arising in partnership taxable years beginning after December 31, 1978.

### *Revenue effect*

These provisions will have no effect on budget receipts.

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<sup>4</sup> For example, if a federally registered partnership has additional gross income, which results in an individual partner having additional adjusted gross income, the partner's medical deduction (under section 213) may be reduced because his 3-percent adjusted gross income floor is increased. The reduction in the medical deduction will be treated as a partnership item and the amount of the additional tax attributable to the decreased medical deduction may be assessed during the 4-year period of limitations.

<sup>5</sup> These general rules may be illustrated with the following example. Assume that partnership A (the first tier partnership) is a federally registered partnership. It has as partners Partnership B (a non-Federally registered partnership), a simple trust, and a subchapter S corporation (collectively, the second tier partners). Each of the partners, beneficiaries or shareholders, respectively, of the second tier partners is an individual taxpayer (ultimate taxpayers). Assume further that the Service assesses a deficiency against each of the ultimate taxpayers based on a disallowance of a deduction claimed by Partnership A. The deduction claimed by Partnership A is a partnership item as to each of the ultimate taxpayers for the following reasons. The deduction is taken into account under the provisions of subchapter K in computing the gross income and deductions of the second tier partners (i.e., Partnership B, the trust and the subchapter S corporation). As such it is a partnership item of each of those entities. The item is a partnership item to the partners of Partnership B, the beneficiaries of the trust, and the shareholders of the subchapter S corporation, because the taxable income of Partnership B, the distributable net income of the trust, and the undistributed taxable income of the subchapter S corporation, all of which are taxable to the ultimate taxpayers, are each affected by the partnership item flowing from Partnership A. Furthermore, it does not matter that the intervening partnership B is a non-Federally registered partnership because once a partnership item has arisen in a federally registered partnership, or passed through a federally registered partnership, it retains its status as a partnership item to all subsequent tiers.

## **TITLE III—PROVISIONS PRIMARILY AFFECTING BUSINESS INCOME TAX**

### **A. CORPORATE RATE REDUCTION**

**(Sec. 301 of the Act and secs. 11, 12, 244(a)(2), 247(a)(2), 511(a), 527(b), 528(b), 802(a), 821, 826(c), 852(b), 857(b), 882, 922(a)(2), 962, 1351(d), 1551, and 1561 of the Code)**

#### ***Prior law***

Under prior law, corporate income was subject to a normal tax of 20 percent on the first \$25,000 of taxable income and 22 percent on taxable income in excess of \$25,000. In addition, a surtax of 26 percent was imposed on corporate taxable income in excess of \$50,000. This rate structure was enacted temporarily in the Tax Reduction Act of 1975 and was extended through the end of 1978 in subsequent legislation.

For taxable years ending after December 31, 1978, the normal tax was scheduled to return to 22 percent on all corporate taxable income, and a 26-percent surtax was to be reimposed on all taxable income in excess of \$25,000. Thus, for taxable years ending after December 31, 1978, corporations would have corporate income tax of 22 percent on the first \$25,000 of taxable income and 48 percent on taxable income in excess of \$25,000.

#### ***Reasons for change***

Congress believed that reduction of the corporate tax rates is necessary to stimulate economic growth through a higher rate of capital investment and to increase employment and efficient use of the labor force. In addition, Congress believed that the reduction in corporate tax rates and the application of graduated rates to corporations will encourage growth in small business by providing relatively greater tax relief to those companies in the form of rate reductions. Of the overall corporate rate cut of \$5 billion, about \$1 billion goes to corporations with taxable income of less than \$100,000.

Graduated corporate tax rates will also reduce the abrupt jump in tax rates under present law as taxable income increases above \$50,000, under the expiring temporary provisions, and above \$25,000, under the permanent provisions in present law. The tax rate increase from 22 percent to 48 percent under present law constitutes a 118-percent increase. Congress believed that this increase imposed too great a tax burden on the increment to taxable income. A more gradual increase from the lowest to highest corporate income tax rate will reduce this large increase in the marginal rate on incremental income.

Moreover, application of the graduated rates to corporations should reduce the impact of the tax laws in the selection of a form of organization for operation of a small business. Under prior law, corporate tax rates increased from 22 percent to 48 percent for taxable income in excess of \$50,000. Reduction in the corporate tax rates and application of graduated rates to corporations would reduce the relative impor-

tance of the tax laws on this choice. As a result, nontax economic factors will receive greater emphasis in selection of the corporate, partnership, or sole proprietorship form for the operation of a small business.

### ***Explanation of provision***

The Act repeals the corporate normal tax and surtax and in their place imposes a five-step tax rate structure on corporate taxable income. The rate structure under the Act reduces the top corporate income tax rate from 48 percent to 46 percent and provides a graduated rate structure on the first \$100,000 of taxable income. The corporate tax rates under the Act are:

<i>Taxable income</i>	<i>Tax rate</i>
\$0 to \$25,000-----	17 percent
\$25,000 to \$50,000-----	20 percent
\$50,000 to \$75,000-----	30 percent
\$75,000 to \$100,000-----	40 percent
Over \$100,000-----	46 percent

The Act continues the special rules for the tax treatment of mutual savings banks conducting a life insurance business, insurance companies, mutual funds (regulated investment companies), and real estate investment trusts. A number of conforming amendments are made to reflect the repeal of the normal tax and surtax and imposition of a graduated tax on corporations. These rules replace the existing rules restricting multiple surtax exemptions with new rules, similar in intent, to prevent abuse of the graduated rate structure.<sup>1</sup>

### ***Effective date***

The provisions are effective for taxable years beginning after December 31, 1978.

The Act (sec. 106) specifically applies the rules for rate changes of fiscal year corporate taxpayers (sec. 21 of the Code) to allow these corporations the benefits of the new corporate rates for that part of their 1978-1979 fiscal year which falls in 1979. Under this provision, fiscal year taxpayers are to compute their tax liability for that year both without regard to these changes and taking these changes into account. The difference in these two amounts is then to be prorated over the fiscal year, and the tax reduction is allowed to the extent of the amount falling in 1979.

### ***Revenue effect***

This provision will reduce budget receipts by \$2,281 million in fiscal year 1979, \$5,286 million in 1980, and \$6,940 million in fiscal year 1983.

The combined effect of extending the present corporate tax rates and the additional revenue effects of enacting the rate structure in this provision will be a reduction in budget receipts of \$3,208 million in fiscal year 1979, \$7,434 million in 1980, and \$9,759 million in 1983.

<sup>1</sup> For example controlled groups (under section 1561) are limited to one \$50,000 surtax exemption which is apportioned among the members of the group. In order to conform to the graduated rate schedules, section 1561 is changed to limit a controlled group to a total of only \$25,000 of taxable income in each of the rate brackets below the 46-percent bracket. Thus, if there are three members of a controlled group and if no plan for unequal apportionment is adopted, each member will be subject to tax at a rate of 17 percent of its first \$8,333 of taxable income, 20 percent of its second \$8,333, 30 percent on its third \$8,333, 40 percent on its fourth \$8,333 and 46 percent on its taxable income in excess of \$33,333.

## **B. INVESTMENT CREDIT PROVISIONS**

### **1. Permanent Extension of 10-percent Credit and \$100,000 Limitation on Used Property (sec. 311 of the Act, secs. 46(a)(2) and 48(c) of the Code, and sec. 301(c)(2) of the Tax Reduction Act of 1975)**

#### ***Prior law***

A credit against income tax liability is provided for a taxpayer's investment in certain types of depreciable business assets. The investment credit rate is presently 10 percent of qualified investment. This rate was increased temporarily from 7 percent to 10 percent under the Tax Reduction Act of 1975 and, as extended under subsequent legislation, was scheduled under prior law to return to 7 percent (4 percent for certain public utility property) in 1981.

Prior law also limited the availability of the credit for investment in qualified used property to \$100,000 in each taxable year for any taxpayer. This limitation was increased temporarily from \$50,000 to \$100,000 under the Tax Reduction Act of 1975, and, as extended under subsequent legislation, was scheduled to return to \$50,000 in 1981.

#### ***Reasons for change***

Since its enactment in 1962, the investment tax credit has been an effective incentive for investment in productive assets. Statistics on such investment show a positive relationship between the level of investment and the availability of the credit. Investment has increased when the credit has been made available or the rate was raised, and investment has decreased when the credit was repealed or rescinded. The effectiveness of the credit arises from the fact that it reduces the purchase price of the equipment and in effect increases the net cash flow after taxes to the investor.

The Congress believed that, with respect to long-term investment, the effectiveness of the credit was reduced by the uncertainty as to whether the present temporary 10-percent credit would be extended or made permanent. This uncertainty could distort orderly investment programs as businesses rush to place equipment in service before the temporary rate is scheduled to expire.

#### ***Explanation of provision***

Under the Act, the temporary investment credit rate of 10 percent for all taxpayers, which was scheduled to return to 7 percent (4 per-

cent for utilities) in 1981, is made permanent.<sup>1</sup> The present temporary \$100,000 annual limitation on used property eligible for the credit, which was scheduled to return to \$50,000 in 1981, is also made permanent. The Act (sec. 141) also extends the provisions for an additional investment credit when employers contribute to employee stock ownership plans (ESOPs) for three years, or from December 31, 1980, through December 31, 1983.

### ***Effective date***

These amendments will become effective on January 1, 1981, when the temporary extensions expire.

### ***Revenue effect***

This provision will reduce budget receipts by \$2,071 million in fiscal year 1981, \$5,201 million in 1982, and \$6,283 million in fiscal year 1983.

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<sup>1</sup> The provisions of section 46(a)(2) were also amended by the Energy Tax Act of 1978. Since this legislation was considered by the Congress prior to the Revenue Act of 1978, those amendments were considered on the basis of the law in effect at that time which was the temporary 10-percent investment tax credit. The Revenue Act of 1978 was signed into law by the President on November 6, 1978, and then the Energy Tax Act of 1978 was signed on November 9, 1978. It is the intention of Congress that the provisions of the Revenue Act of 1978 will be implemented as passed by the Congress and conflicts with the Energy Tax Act will be resolved by treating the Revenue Act of 1978 as having been enacted last. It is expected that Congress will re-enact the provisions of the Revenue Act of 1978 if necessary to make the 10-percent investment credit permanent.



## **2. Increase in Limitations on Investment Credit to 90 Percent of Tax Liability (sec. 312 of the Act and sec. 46(a) of the Code)**

### ***Prior law***

Generally, the amount of the investment credit a taxpayer was able to apply against his tax liability in any one year could not exceed the first \$25,000 of tax liability, plus 50 percent of the tax liability in excess of \$25,000. Special limitations had been provided for public utility property, under which the 50 percent limit was increased to 100 percent for 1975 and 1976, was 90 percent for 1977, and was to decline by 10 percentage points in each succeeding year until returning to the generally applicable 50-percent limit in 1981. Similar increases in the tax liability limitation were made available (under the Tax Reform Act of 1976) to railroads and airlines for their investment in transportation property; taxpayers in both industries were allowed to apply their investment credits against 100 percent of tax liability for 1977 and 1978, and the limitation was to be reduced by 10 percentage points in each subsequent year until returning to 50 percent in 1983.

Generally, investment credits which are not used in the year earned, because of the limitation on the amount of tax liability that may be offset, may be carried back to the preceding three taxable years and carried over to the seven following taxable years. Credits which are not used during these carryback and carryover periods expire, and the taxpayer no longer obtains tax benefits from the credits.

### ***Reasons for change***

The present limit on the amount of tax liability that can be offset by the investment credit usually does not restrict a taxpayer's ability to use these credits, but only affects the timing in the use of the credits. However, there are unusual situations where the present limitations, in conjunction with other circumstances, may prevent the full use of the credit and in these situations the limitation becomes a disincentive to investment. For these reasons, the Congress believed that increasing the tax liability limitation will have a beneficial effect on capital formation.

### ***Explanation of provision***

The Act increases the present 50-percent tax liability limitation to 90 percent, to be phased in at an additional 10 percentage points per year beginning with taxable years which end in 1979. As a result, the limitation will be 60 percent for taxable years ending in 1979, 70 percent for 1980, 80 percent for 1981, and 90 percent for 1982 and subsequent years. For example, in taxable years ending in 1980, taxpayers in general will be entitled to use investment credits (including carryover and carryback credits) to offset the first \$25,000 of tax liability dollar-for-dollar, and 70 percent of tax liability in excess of \$25,000.

Special rules are also provided for railroads, airlines, and certain utilities so that the phase-in of this increase to the limitation does not

reduce the amounts of investment credits these taxpayers may be entitled to use under the special increased limitations available to them in present law. For example, present law provides both railroads and airlines, if eligible, with a limitation of up to 80 percent for 1980, when the generally applicable limitations under the Act will be 70 percent. In this situation, eligible taxpayers investing in railroad property or in airline property may apply whichever limitation that entitles them to use the greater amount of investment credits.

***Effective date***

These amendments are effective for taxable years ending after December 31, 1978.

***Revenue effect***

This provision will reduce budget receipts by \$129 million in fiscal year 1979, \$441 million in 1980, and \$782 million in fiscal year 1983.

### **3. Increased Credit for Pollution Control Facilities (sec. 313 of the Act and sec. 46(c) of the Code)**

#### ***Prior law***

The investment credit was allowed for only one-half of the investment in pollution control facilities for which five-year amortization had been elected.

#### ***Reasons for change***

Shifts from oil or gas to coal for fuel require investment in pollution control equipment not ordinarily necessary with the use of oil or gas. Furthermore, increasing attention to sources of environmental pollution has caused greater numbers of businesses to be required to install pollution control equipment.

In many cases, installation of the equipment in an existing facility neither increases productive efficiency nor increases the capacity to produce. The costs of pollution control then must be included in product prices, which has inflationary consequences and tends to reduce the rate of return on investment.

The need to use investable funds for pollution control, of course, reduces the funds available for investment in equipment directly related to the productive process. Congress has re-examined this area and has concluded that it is desirable to make the full investment credit available in conjunction with the election of five-year amortization because the taxpayer has incurred these costs in order to carry out a social policy. Congress also believes that the consequent reduction in the costs of complying with the antipollution regulations will free internally generated funds for investment in equipment which will increase productive capacity and efficiency.

#### ***Explanation of provisions***

The Act relaxes the restriction in prior law limiting the amount of investment credit available for pollution control facilities which a taxpayer has elected to amortize over a five-year period. Under the Act, the full investment credit will be allowed generally on pollution control facilities which are amortized over 5 years and which have actual useful lives of at least 5 years. (Pollution control facilities which have useful lives of 3 or 4 years will continue to be subject to the present law rule which, in effect, limits the credit to one-third of the full credit.)

A limitation is provided where five-year amortization is elected and the pollution control facility has also been financed in whole or in part by tax-exempt industrial development bonds. In order to reduce the duplication of tax incentives in such situations, the Act limits the amount of credit to, in effect, one-half of the full credit. In cases where the proceeds of industrial development bonds have been used in part to finance the construction of a plant or factory, including a pollution control facility for which the taxpayer elects five-year amor-

tization, a pro-rata portion of the tax-exempt financing should be allocated to the pollution control facility for purposes of applying this limitation.

***Effective date***

The provision applies to property acquired by the taxpayer after December 31, 1978 and, where property was constructed by the taxpayer, to the extent of basis attributable to construction after December 31, 1978.

***Revenue effect***

This provision will reduce budget receipts by \$6 million in fiscal year 1979, \$18 million in 1980, and \$104 million in fiscal year 1983.

#### 4. Investment Credit for Single Purpose Agricultural Structures (sec. 314 of the Act and sec. 48(a)(1) of the Code)

##### *Prior law*

Property eligible for the investment tax credit includes tangible personal property (such as machinery and equipment) which is used in a trade or business or for the production of income. The investment credit is also allowed for other tangible property which is used as an integral part of manufacturing, production, extraction, or in furnishing certain utility services, even though such tangible property may otherwise be considered real (and not personal) property under local law. Farming is considered a production activity so that such items as fences, drain tiles, paved barnyards, and water wells are eligible for the credit even though these items would be considered real property under local law.<sup>1</sup>

Under existing law, buildings and their structural components generally are not eligible for the investment credit. Ineligible buildings have been generally considered to include any structure which encloses a space within its walls (and usually covered by a roof) which is used primarily to provide shelter or working space. Examples of buildings include factory and office buildings, warehouses, and barns (Regs. § 1.48-1(e)(1)). While the Internal Revenue Service had ruled that barns, stables, and poultry houses were buildings and were ineligible for the credit, certain single purpose structures have not been considered ineligible buildings.<sup>2</sup> A single (or special) purpose structure which qualifies for the credit is one which houses property used as an integral part of a production activity (including farming) where the structure is so closely related to the use of the property that it is clearly expected to be replaced when the property it houses is replaced. One characteristic of this type of structure is that it cannot be used economically for any purpose other than that related to the property it houses.<sup>3</sup>

In the Senate Finance Committee report on the Revenue Act of 1971, Congress stated that single purpose structures used in unitary hog-raising systems would be considered single purpose structures which qualify for the investment credit and would not be considered buildings.<sup>4</sup> The Internal Revenue Service continued to approach the question of eligibility of single purpose farm structures on a case-by-case basis. For example, in three recent cases, the IRS contended that structures which are designed and used for poultry-raising and egg-producing activities were not eligible for the investment credit.<sup>5</sup> Although the

<sup>1</sup> Rev. Rul. 66-89, 1966-1 Cum. Bull. 7.

<sup>2</sup> *Ibid.*

<sup>3</sup> Regs. § 1.48-1(e)(1).

<sup>4</sup> S. Rept. No. 92-437, 92d Cong., 1st Sess. (1971), 29-30.

<sup>5</sup> *Melvin Satrum*, 62 T.C. 413 (1974), *conacq.*, 1978-23 Int. Rev. Bull. 7 (June 5, 1978); *Starr Farms, Inc. v. U.S.*, 78-1 U.S.T.C. ¶ 9183 (W.D. Ark. 1977); *Walter Sheffield Poultry Co.*, T.C. Memo 1978-308.

IRS was reversed in two of these cases, it was understood that the Service continued to adhere to the position that single purpose poultry-raising and egg-producing structures were not generally eligible for the investment credit.

Greenhouses are structures which provide an environment for the controlled growth of flowers and other plants. These structures also provide working space for persons who care for the flowers and plants within the greenhouse. It is the position of the Internal Revenue Service that greenhouses are buildings and consequently are ineligible for the credit. This position is based on the fact that these structures provide working space for persons tending the plants. The Service's position was sustained in two Tax Court cases decided in 1972.<sup>6</sup> However, the Tax Court was overruled in one of these cases on appeal.<sup>7</sup> In this latter case, the Ninth Circuit Court of Appeals found that the workers' activities in the greenhouse were "merely supportive of, and ancillary to" the principal use of the structure of providing an environment for controlled plant growth.

### ***Reasons for change***

When the investment tax credit was restored in the Revenue Act of 1971, the Congress intended to make it clear that the credit was to apply to single purpose agricultural structures. Despite this expression of intent, the Internal Revenue Service has continued a case-by-case approach with respect to application of the credit to single purpose agricultural structures and enclosures used for raising poultry, livestock, horticultural products or for producing eggs. Taxpayers' litigation to establish their right to these credits is both expensive and troublesome, particularly in cases involving small farmers with limited amounts of eligible property. As a result of this continuing controversy, the Congress decided to specifically provide that these agricultural structures are eligible for the investment credit.

### ***Explanation of provision***

This provision makes structures or enclosures used for single purpose livestock or plant production specifically eligible for the investment tax credit.<sup>8</sup> To be eligible for the credit under the Act, the structure must be both specially designed and used solely for the production of poultry, eggs, livestock, or plants. For example, if a portion of a greenhouse is used to sell plants (for example, by installation of a check-out stand for customers), the greenhouse will not qualify for the credit. However, the fact that a greenhouse provides working space for those who care for the plants will not make the greenhouse ineligible for the credit. A structure ceases to be a qualifying structure if it is used for a purpose (such as for storage of feed or equipment)

<sup>6</sup> *Sunnyside Nurseries*, 59 T.C. 113 (1972); *Arne Thirup*, 59 T.C. 122 (1972).

<sup>7</sup> *Thirup et al. v. Comm.*, 508 F. 2d 918, 75-1 U.S.T.C. ¶ 9158 (9th Cir. 1974). This case was followed in *Stuppy, Inc. v. United States*, 78-2 U.S.T.C. ¶ 9664 (W.D. Mo. 1978).

<sup>8</sup> This provision was added to the Revenue Act of 1978 by a Senate Finance Committee amendment. A similar provision was the subject of a separate bill, H.R. 12846, which was reported by the House Ways and Means Committee (H. Rept. No. 95-1761, October 11, 1978), and was passed by the House on October 13, 1978.

which does not qualify it for the investment credit under this or other definitions of qualifying property. Mere vacancy of the structure will not violate the usage test, nor will the use of a minor portion of a structure for necessary post-productive activities which are ancillary to the raising of livestock or to the cultivation, production or harvesting of plants or plant products. Generally, such ancillary uses would include loading chutes and related facilities for livestock and sorting and packing areas for unprocessed plants and plant products. However, the use of structures or enclosures for processing activities, such as slaughtering or packaging meat, or marketing activities, such as displaying plants or other marketable products, would make them ineligible.

It is intended that this provision be broadly construed to apply to all types of single purpose structures and enclosures used to breed, raise and feed livestock and poultry (including the production of eggs and milk), and for the cultivation of plants. Thus, this provision will cover unitary hog, poultry, and cattle-raising systems, milking parlors, and commercial mushroom houses or greenhouses used to produce either plants or plant products.

If a single purpose structure becomes ineligible because of the usage test within seven years from the time it was placed in service, investment credits claimed on the structure may be partially or entirely recaptured under the investment credit recapture rules in present law. In addition, Congress wishes to emphasize that the specific provisions concerning the eligibility of these structures for the investment credit are not to create a negative inference regarding the eligibility of other single purpose agricultural and productive structures for the credit under existing law.

The amendment is not intended to apply to general purpose agricultural structures, such as barns and other farm structures, which can be adapted to a variety of uses.

In addition, the Senate Finance Committee report stated that tangible personal property already eligible for the investment tax credit includes special lighting (including lighting to illuminate the exterior of a building or store, but not lighting to illuminate parking areas), false balconies, and other exterior ornamentation that have no more than an incidental relationship to the operation or maintenance of a building, and identity symbols that identify or relate to a particular retail establishment or restaurant such as special materials attached to the exterior or interior of a building or store and signs (other than billboards). Similarly, the Senate Finance Committee report stated that property eligible for the investment tax credit under prior law included floor coverings which are not an integral part of the floor itself, such as floor tile generally installed in a manner to be readily removed (that is it is not cemented, mudded, or otherwise permanently affixed to the building floor but, instead, has adhesives applied which are designed to ease its removal), carpeting, wall panel inserts such as those designed to contain condiments or to serve as a framing for pictures of the products of a retail establishment, beverage bars, ornamental fixtures (such as coats-of-arms), artifacts (if depreciable), booths for seating, movable and removable partitions, and large and small pictures of scenery, persons, and the like which are attached to walls or suspended from the ceiling.

***Effective date***

This provision is effective for open taxable years which end on or after August 15, 1971.

***Revenue effect***

This provision will reduce budget receipts by \$53 million in fiscal year 1979, \$33 million in fiscal year 1980, and \$26 million in fiscal year 1983; the estimates for fiscal years 1979 and 1980 include the effects of reductions in liabilities from previous years.



## **5. Investment Credit for Certain Rehabilitated Structures (sec. 315 of the Act and sec. 48 of the Code)**

### ***Prior law***

Property eligible for the investment tax credit has included tangible personal property (such as machinery and equipment) which is used in a trade or business or for the production of income. The investment credit has been allowed for other tangible property which is used in manufacturing, production, extraction, or as an integral part of furnishing transportation, communications, or electrical, gas, or other utility services, even though such tangible property may otherwise be considered real (and not personal) property under local law. Buildings and their structural components have not been eligible for the credit nor have expenditures for the purpose of rehabilitating or renovating existing buildings or structures.

### ***Reasons for change***

Buildings and their structural components have not been eligible for the investment tax credit since it was enacted in 1962. At that time, the Congress was primarily concerned about the substantially greater average age and lower efficiency of machinery and equipment in domestic manufacturing facilities in comparison with the facilities of major foreign producers of the same products.

Presently, there is a similar concern about the declining usefulness of existing, older buildings throughout the country, primarily in central cities and older neighborhoods of all communities. This situation, in part, reflects basic demographic and economic trends. It also is a response to changing architectural and engineering designs of buildings and the internal placement and flow of activities in manufacturing and commercial enterprise.

The Congress believed that it was appropriate now to extend the initial policy objective of the investment credit to enable business to rehabilitate and modernize existing structures. This change in the investment credit should promote greater stability in the economic vitality of areas that have been deteriorating.

### ***Explanation of provisions***

#### ***Qualifying expenditures***

The Act extends the investment credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities except those, such as apartments, which are used for residential purposes. Eligible buildings include factories, warehouses, office buildings, hotels,<sup>1</sup> and retail and wholesale stores.

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<sup>1</sup> Buildings used for lodging generally will not be eligible (sec. 48(a)(3)). However, the exception for lodging facilities would not apply to rehabilitation of hotels and motels where the predominant portion of the accommodations is used by transients and section 48(a)(3), by its terms, does not apply.

The type of eligible building is to be determined on the basis of its use when placed in service after the rehabilitation, e.g., an apartment building rehabilitated for use as an office building would be treated as an eligible office building.

In order to qualify as a rehabilitation expenditure, the expenditure must be incurred after October 31, 1978, in connection with the rehabilitation or reconstruction of a building which has been in use for a period of at least 20 years before the commencement of the rehabilitation. For this purpose, the determination of the 20-year period would be unaffected by periods during which a building was vacant or devoted to a personal use. In addition, the 20-year test is to be applied to the building without regard to the number of owners. The running of the 20-year period would commence at the earlier of the time depreciation deductions were first allowable with respect to the building or when it was first placed in use for any purpose (Treas. Reg. sec. 1.46-3(d)).

A rehabilitation of a building, or a major portion thereof, which had previously been rehabilitated would not be eligible for the credit until 20 years after the building was placed in service following completion of a prior rehabilitation for which a credit was allowed. (However, this latter limitation should not be interpreted to require continuous rehabilitation activity and preclude allowing the credit where there are delays between phases of a rehabilitation plan.) In addition, in order to exclude minor repairs or improvements, the costs must be of the type which must be capitalized under existing law (and not expensed) and must be incurred for property which has a useful life of at least five years.

In situations where a part of a building is rehabilitated, the rehabilitation costs will qualify for the credit only if the rehabilitated part constitutes a "major portion" of the building. In determining whether a part of a building constitutes a major portion, such factors as volume, floor space, and functional differences between the rehabilitated and unrehabilitated parts of the building should be taken into consideration. For example, where a substantial part of a building is used for commercial activities (such as retail stores) and another part is used for warehousing, each part will usually constitute a major portion of the building for purposes of these provisions. In addition, a rehabilitation of leased premises, by either the lessor or the lessee, of the entire leasehold interest of a major portion of a building will be considered an eligible rehabilitation.

Under these rules and existing law, qualifying expenditures will be eligible for a two-thirds investment credit if the improvements attributable to the expenditures have a useful life of five or six years, and a full credit where the useful life is seven years or more. Useful life for this purpose is the useful life used by the taxpayer for depreciation purposes. In addition, the existing rules concerning the recapture of investment credits will apply so that, if the property is disposed of or ceases to be qualifying property before the end of the appropriate useful life for which the credit was allowed, all or part of the credit will be recaptured.

Qualified rehabilitation costs will be considered as incurred for new property and, therefore, not subject to the \$100,000 used property

limitation, except to the extent such costs are for property (such as used elevators) which otherwise qualify for the investment credit. In these latter cases, the costs will not be considered as rehabilitation expenditures.

For purposes of this provision, the rehabilitation of a building will include the renovation, restoration, and reconstruction of an existing building. Thus, interior or exterior renovation or restoration to materially extend the useful life of the building, to significantly upgrade its usefulness, or to preserve it will normally qualify. Capital expenditures for the replacement of plumbing, electrical wiring, flooring, permanent interior partitions and walls, and the heating or air conditioning systems (including temperature control systems) could qualify as qualified rehabilitation expenditures when incurred in connection with a rehabilitation.<sup>2</sup> In addition, expenditures for the removal of existing interior walls, plumbing, electrical wiring, flooring, etc., would qualify if the expenditures were incurred in connection with the rehabilitation of a building and treated as capital expenditures for property with a useful life of at least 5 years.

If a rehabilitation is undertaken by a lessee, the lessee is eligible for the investment credit for qualified rehabilitation costs incurred by him, to the extent these costs are required to be capitalized by him and are not treated under other provisions of the law as payments in lieu of rent. Costs for which a lessee is entitled to reimbursement from the lessor would be taken into account for credit purposes by the lessor rather than the lessee. In determining qualified investment by a lessee, the useful life of a lessee's rehabilitation costs will be the useful life allowed to the lessee for purposes of depreciation or amortization of these costs under Code sections 167 and 178.

In the case of a rehabilitation by a lessor, the investment credit may be flowed through to a lessee under regulations prescribed by the Secretary of the Treasury under code section 48(d).

#### *Nonqualifying expenditures*

The costs of acquiring a building or an interest in a building (such as a leasehold interest) will not be considered as qualifying expenditures nor will costs that are incurred in connection with facilities, such as parking lots, which are related to an existing building. In addition, construction costs for a new building, or for completing a new building after it has been placed in service, will not qualify.

Limitations are also provided to exclude costs incurred for new construction or enlargement of an existing building. In the case of an enlargement, costs will not be considered qualifying expenditures to the extent incurred to expand the total volume of the existing building. However, an increase in floor space resulting from interior remodeling will not be considered an enlargement. In addition, construction costs will be considered for new construction rather than for the rehabilitation of a building if more than 25 percent of the existing external

<sup>2</sup> Under present law, it may be difficult to classify certain items as either tangible personal property which is eligible for the investment tax credit or as structural components of a building which are ineligible. To the extent attributable to a qualified rehabilitation, the classification problem for these items would be eliminated because they would be eligible for the credit under either classification.

walls of the building are replaced. This latter restriction, however, is not intended to be interpreted to cover situations where existing walls are covered (e.g., the outer walls are covered by new siding in connection with the rehabilitation) or reinforced.

*Certified historic structures*

In the case where expenditures are eligible for 5-year rapid amortization as rehabilitation expenditures for a certified historic structure, a taxpayer must choose between the benefits of 5-year rapid amortization for the rehabilitation expenditures or the investment tax credit on the expenditures. If rapid amortization is chosen, the expenditures will not be eligible for the investment tax credit. In addition, rehabilitation expenditures in connection with a certified historic structure must themselves be certified as appropriate by the Secretary of the Interior in order to qualify for the investment credit in those situations where the taxpayer elects to claim the credit rather than 5-year amortization.

***Effective date***

These amendments are effective for taxable years ending after October 31, 1978, with respect to qualifying rehabilitation expenditures incurred after that date. The amendment relating to rehabilitated certified historic structures applies to property placed in service after October 31, 1978.

***Revenue effect***

This provision will reduce budget receipts by \$67 million in fiscal year 1979, \$181 million in 1980, and \$238 million in fiscal year 1983.

## **6. Investment Credit for Cooperatives (sec. 316 of the Act and sec. 46 of the Code)**

### ***Prior law***

Under present law, cooperatives are taxed as corporations. However, unlike regular corporations, cooperatives are allowed to deduct certain payments and allocations made to patrons and shareholders (sec. 1382 (b) and (c)). Patrons are those persons with whom, or for whom, the cooperative does business on a cooperative basis. With certain exceptions, the patrons include the deductible payments and allocations in their taxable income (sec. 1385).

Because of this special treatment, the amount of otherwise allowable investment credit which could have been used by a cooperative was limited under prior law by a fraction, the numerator of which was the cooperative's taxable income and the denominator of which was the cooperative's taxable income plus the deductible payments made to patrons and shareholders (sec. 46(e) (2) (C)). The portion not allowed to the cooperative was not passed through the patrons.

### ***Reasons for change***

Cooperatives play a significant role in the American economy, particularly in the agricultural sector. The capital needs of cooperatives to finance expansion and modernization, coupled with the reduced level of investment credit available to these taxpayers, both hinders their growth and reduces the amount of patronage distributions which flow through to patrons. In light of these considerations and because the reductions in the corporate income tax rates (also provided in the Act) are of relatively limited benefit to cooperatives, the Congress decided to liberalize the investment credit as it applies to cooperatives.

### ***Explanation of provisions***

The Act allows cooperatives, including farmer's cooperatives and other similar cooperative organizations (as defined in Code section 1381(a)), to claim the investment credit to the same extent it is available for taxpayers in general. The credit would not be reduced to reflect the deduction for patronage dividends, as under prior law.

The investment credit earned by the cooperative for a taxable year will be applied to reduce the cooperative's tax liability for that taxable year. To the extent the cooperative cannot use an investment credit in the current year, the credit will not be carried back or carried forward but will be allocated to the patrons of the cooperative. However, it is not intended that these new rules apply to carryover credits of the cooperative from years prior to the effective date of this provision. As a result, the cooperative must apply these carryover credits first to its current year tax liability, which may indirectly increase the amount of credits allocated to patrons for the current year. In addition, credits disallowed to cooperatives under section 46(e) for taxable years ending prior to the effective date are not revived and may not be carried over or passed through to the patrons.

The investment credit rules (sections 46-48) will generally be applied at the level of the cooperative. Thus, the determination of qualified investment and useful lives will be made by the cooperative. It will compute the amount of credits for the taxable year and will apply the credits to its tax liability to the extent allowed for the taxable year and apportion the remainder of these credits to its patrons. The passed-through credits are apportioned among the patrons on the basis of the quantity or value of business done with or for the cooperative's patrons for the taxable year.

The cooperative will report to the Internal Revenue Service the amount of credits apportioned to each patron for the taxable year using the same reporting system as is used for reporting patronage dividends and other distributions which are taxable to the patron for the taxable year.

The patron to whom investment credits are allocated is required to report these credits on his income tax return for the first taxable year which includes the payment period for the cooperative's taxable year in which the cooperative earned the credit. The tax liability limitation (under section 46(a)(3)) and carryback and carryover rules (under section 46(b)) will be applied by the patron to the credits allocated to him by the cooperative.

With respect to any credit passed through to patrons, the investment credit recapture provisions are to be applied by treating the cooperative as the taxpayer. If there is an early disposition of the property, which is subject to recapture under section 47, any recapture of credit will be made at the level of the cooperative and no recapture will be required of the patrons. The credit passed through to the patrons will be viewed as a credit used by the cooperative. Also, the carryover or carryback credits of patrons will not be affected by a disposition of property by the cooperative.

### ***Effective date***

These amendments apply to taxable years ending after October 31, 1978.

### ***Revenue effect***

This provision will reduce budget receipts by \$20 million in fiscal year 1979, \$33 million in fiscal year 1980, and \$39 million in fiscal year 1983.

## **7. Transfers to ConRail not Treated as Dispositions for Purposes of the Investment Credit (sec. 317 of the Act and sec 47(b) of the Code)**

### ***Prior law***

On April 1, 1976, a number of insolvent midwestern and northeastern railroads, along with many of their subsidiaries and affiliates, transferred their railroad properties to the Consolidated Rail Corporation (ConRail). These transfers were mandated and approved by the Congress<sup>1</sup> in order to provide financially self-sustaining rail services in areas served by these bankrupt railroads.

Under the legislation which established it, ConRail, a taxable corporation, was to acquire, rehabilitate, and operate the railroad properties. The transferor railroads (and their subsidiaries and affiliates) received ConRail stock and certificates of value issued by the United States Railway Association, a nonprofit Government corporation formed to oversee the ConRail reorganization.

In 1976, the Congress also enacted legislation to deal with certain of the tax consequences of this reorganization to ConRail, the transferor railroads, and the shareholders and creditors of the transferor railroads. Under this legislation,<sup>2</sup> the transfer of rail properties to ConRail was treated like reorganizations in general (and other bankrupt railroad reorganizations in particular) so that the transferor companies and their shareholders and security holders did not recognize gain or loss on the transfer and ConRail received a carryover basis in the properties it acquired.

However, this 1976 tax legislation did not deal with investment credit recapture which might arise to the transferor railroads because of the ConRail reorganization. In contrast, present law generally provides an exemption from investment credit recapture where assets are transferred in a tax-free reorganization.

### ***Reasons for change***

Since the Congress last considered the tax aspects of the ConRail reorganization in 1976, it has noted that a transferor railroad which was required to transfer its rail properties to ConRail may be subject to tax on this transfer because of investment credit recapture, even though present law generally provides an exemption from investment credit recapture where assets are acquired in a tax-free reorganization.

The Act corrects this unanticipated result arising from the Con Rail reorganization.

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<sup>1</sup> The facilitating legislation for the transfers was the Regional Rail Reorganization Act of 1973 (P.L. 93-236, approved January 2, 1974) and the Railroad Revitalization and Regulatory Reform Act of 1976 (P.L. 94-210, approved February 5, 1976).

<sup>2</sup> P. L. 94-253, approved March 31, 1976.

### ***Explanation of provisions***

The Act adds an exception to the investment credit recapture rules (sec. 47(b)) so that a transferor railroad will not be subject to additional tax on its transfer of rail properties to ConRail.<sup>3</sup> However, it is intended that investment credits which are not subject to recapture because of this provision are to be treated as other benefits to the same extent that any other tax benefits are so treated for purposes of the special court's determination of compensation to the transferor railroads under sections 303 and 306 of the Regional Rail Reorganization Act of 1973.

### ***Effective date***

This amendment applies to taxable years ending after March 31, 1976.

### ***Revenue effect***

This provision will reduce budget receipts by \$3 million in fiscal year 1979.

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<sup>3</sup> This provision was added to the Revenue Act of 1978 by a Senate Finance Committee amendment. The provision was included in a separate bill, H.R. 10653, which was reported by the House Ways and Means Committee (H. Rept. No. 95-1539, September 6, 1978) and was passed by the House on October 3, 1978.



### C. TARGETED JOBS CREDIT, WIN CREDIT

#### 1. Targeted Jobs Credit (sec. 321 of the Act and secs. 51, 52, and 53 of the Code)

##### *Prior law*

The Tax Reduction and Simplification Act of 1977 provided a new jobs tax credit for 1977 and 1978. The credit was 50 percent of the increase in each employer's wage base under the Federal Unemployment Tax Act (FUTA) above 102 percent of that wage base in the previous year. The FUTA base for 1977 consisted of wages paid of up to \$4,200 per employee.<sup>1</sup> The employer's deduction for wages was reduced by the amount of the credit. Therefore, although the maximum gross credit for each new employee was \$2,100, the actual reduction in taxes per employee ranged from \$1,806 (for a taxpayer in the 14-percent tax bracket) to \$630 (for a taxpayer in the 70-percent bracket).

The total amount of the credit had four limitations: (1) the credit could not be more than 50 percent of the increase in total wages paid by the employer for the year above 105 percent of total wages paid by the employer in the previous year, (2) the credit could be no more than 25 percent of the current year's FUTA wages, (3) the credit for a year could not exceed \$100,000, and (4) the credit could not exceed the taxpayer's tax liability. Credits which exceeded tax liability for a year could be carried back for 3 years and carried forward for 7 years.

Although most employers were able to use the returns they filed for purposes of complying with FUTA as a basis for claiming the credit, special rules were provided for businesses, such as farms and railroads, not covered under FUTA.<sup>2</sup> Special rules also were provided for computation of the credit by groups of companies under common control, for businesses with employees working abroad, and for businesses affected by acquisitions, dispositions, and other changes in business form. Additional rules were provided for allocating the credit among members of a partnership and of a subchapter S corporation.

Prior law (adopted in the 1977 Act) also provided an additional nonincremental credit equal to 10 percent of the first \$4,200 of FUTA wages paid to handicapped individuals (including handicapped veterans) who received vocational rehabilitation. The credit was based on the first \$4,200 of wages paid to a handicapped individual whose first FUTA wages from the employer were paid in 1977 or 1978. Only wages paid during the 1-year period beginning when the individual was first paid FUTA wages by the employer were taken into account

<sup>1</sup> For 1978, the FUTA wage base went up to \$6,000. In order to make the 1978 wage base comparable with 1977 for purposes of the jobs credit, prior law required that only the first \$4,200 of the FUTA wage base for each employee be included in the computation.

<sup>2</sup> Generally, employers who employ one or more employees in covered employment for at least 20 weeks in the current or preceding calendar year or who pay wages of \$1,500 or more during any calendar quarter of the current or preceding calendar year are covered under FUTA.

in computing the 10-percent credit. The credit for handicapped workers could not be greater than one-fifth of the regular 50-percent new jobs credit which would have been allowable without regard to the \$100,000 limitation. However, the special 10-percent credit was not itself subject to any specific dollar limitation.

### ***Reasons for change***

The Congress believed that the unemployment rate has declined sufficiently so that it is appropriate to focus employment incentives on those individuals who have high unemployment rates even when the national unemployment rate is low, and on other groups with special employment needs.

The Congress, therefore, decided to let the current new jobs credit expire at the end of 1978. In its place, the Congress designed a provision which should provide an incentive for private employers to hire individuals in seven target groups. The groups have been defined on the basis of their low income or because their employment should be encouraged. Included among the targeted individuals are vocational rehabilitation referrals, economically disadvantaged youths, economically disadvantaged Vietnam-era veterans, Supplemental Security Income recipients, general assistance recipients, youths participating in a cooperative education program, and economically disadvantaged convicts.

### ***Explanation of provision***

#### ***General rules***

Under the Act, it was intended that the jobs credit would be extended for a 3-year period to apply to eligible wages paid before 1982. However, due to a typographical error in the statute, the credit is extended only for a 2-year period, i.e., wages paid after 1980 are ineligible. It is anticipated that corrective legislation will be introduced in the 96th Congress.

Also, the Act amends the provisions of the jobs credit so that a credit is allowed only for hiring members of seven target groups. The credit allowed to a taxpayer who elects the credit in any taxable year is equal to 50 percent of qualified first-year wages and 25 percent of qualified second-year wages. Qualified first-year wages consist of wages attributable to service rendered by a member of a target group during the one-year period beginning with the day the individual first begins work for the employer. For a vocational rehabilitation referral, however, the period begins the day the individual begins work for the employer on or after the beginning of this individual's vocational rehabilitation plan. Qualified second-year wages consist of the wages attributable to service rendered during the one-year period which begins at the close of the first year described just above. Thus, the date on which the wages are paid does not determine whether the wages are first-year or second-year wages; rather, the wages must be attributed to the period during which the work was performed. With respect to employees in the target groups other than vocational rehabilitation referrals for whom credits currently are being claimed under existing law, qualified wages do not include wages paid or incurred after December 31, 1978, to employees who were first hired by the employer before September 27, 1978. However,

employees who are hired on or after that date shall be treated, for the purpose of applying the amendments made by this section of the Act, as if they began work for the employer on January 1, 1979, or, if later, the actual date they began work.

No more than \$6,000 of wages during either the first or second year of employment may be taken into account with respect to any individual.<sup>3</sup> Thus, the maximum credit per individual is \$3,000 in the first year of employment and \$1,500 in the second year of employment. However, the deduction for wages is reduced by the amount of the credit (determined without regard to the tax liability limitation). Thus, for an employer who hires an eligible employee who earns \$6,000 in his first year of employment, the credit causes an actual reduction in taxes which ranges from \$900 (for an employer in the 70-percent bracket) to \$2,580 (for an employer in the 14-percent bracket).

Two other rules apply to the definition of qualified wages. First, any wages paid to an employee for whom an employer is simultaneously receiving payments for on-the-job training under Federally-funded programs such as the Comprehensive Employment and Training Act (CETA) would not be qualified wages. Second, no wages paid to an employee for whom a WIN—welfare recipient credit is claimed are qualified wages.

#### *Certification of members of target groups*

In order to encourage employer participation in the credit, the Act establishes certification provisions which relieve the employer of responsibility for proving to the Internal Revenue Service that an individual is a member of a target group. Rather, the Act requires that the Secretaries of Treasury and Labor jointly designate a single employment agency in each locality, such as the Employment Service, to make this determination and to issue a certificate which, without further investigation on the part of the employer, is sufficient evidence that the individual is a member of such group.

The Act provides that this designated local employment agency issue certification even when another agency, such as the Social Security Administration or a state welfare agency, is in a position to determine whether an individual is a member of a target group. There are several reasons for this provision. First, the Congress believes that by placing responsibility for certifications with the designated local employment agency, the labor market exchange role of such agencies will be strengthened. Second, the various other agencies involved would be extremely reluctant to deal with a myriad of employer inquiries, but would be willing to deal with a single local employment agency.

<sup>3</sup> For example, if an employer with a calendar year taxable year hires an eligible employee who begins work on September 1, 1979, and pays him \$2,500 in that taxable year, the employer is eligible for a credit of 50 percent of the \$2,500, or \$1,250 in that taxable year. For the next taxable year, the employer also is eligible for a 50-percent credit on the next \$3,500 paid to that employee through August 31, 1980. No credit is allowed on any additional wages paid to that employee through August 31, 1980. However, the employer is eligible for the 25-percent credit on any wages paid to the employee beginning September 1, 1980 until the total wages paid to the employee from that date (through August 30, 1981) equal \$6,000 (assuming that, for 1981 wages, corrective legislation as mentioned previously is enacted).

Furthermore, the Congress believes that the credit can be effective only if the Secretary of Labor, the Employment Service, and local employment and training agencies aggressively promote the credit, use it as a tool in finding jobs for members of the target groups, and provide prompt certification. The Act explicitly provides that the Secretary of Labor, in consultation with the Internal Revenue Service, must take whatever steps are necessary to keep employers informed of the availability of the credit, including use of the mass media and private industry councils established under CETA. The Congress believes that only through such publicity, and through the resulting interchange between employers and public employment agencies, will the intended results be achieved.

### *Target groups*

(1) *Vocational rehabilitation referrals.*—Vocational rehabilitation referrals are those individuals who have a physical or mental disability which constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a state plan approved under the Rehabilitation Act of 1973, or under a rehabilitation plan for veterans carried out under chapter 31 of title 38, U.S. Code. Certification can be performed by the designated local employment agency, upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(2) *Economically disadvantaged youths.*—Economically disadvantaged youths are individuals at least age 18 but not age 25 on the date they are hired by employers, and who are members of economically disadvantaged families (defined as families with income during the preceding 6 months, which on an annual basis was less than 70 percent of the Bureau of Labor Statistics lower living standard as determined by the designated local employment agency). This definition of economically disadvantaged families is the same as that used to determine eligibility for various components of the CETA program. In preparing the regulations for this tax credit and CETA, and in implementing these programs, the Secretaries of Treasury and Labor should coordinate their interpretations of this definition to the maximum extent feasible.

(3) *Economically disadvantaged Vietnam-era veterans.*—The third target group consists of Vietnam-era veterans certified by the designated local employment agency as under the age of 35 on the date they are hired by the employer and who are members of economically disadvantaged families. For purposes of the Act, a Vietnam-era veteran is an individual who has served on active duty (other than for training) in the Armed Forces more than 180 days, or who has been discharged or released from active duty in the Armed Forces for a service-connected disability, but in either case the active duty must have taken place after August 4, 1964, and before May 8, 1975. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual is hired by the employer.

This latter rule is intended to prevent employers that hire current members of the armed services (or those recently departed from service) from receiving the credit. The definition of an economically disadvantaged family and the procedures for certifying to the employer that an individual is a member of such a family are the same as those discussed above.

(4) *SSI recipients*.—SSI recipients are those receiving either Supplemental Security Income under Title XVI of the Social Security Act or State supplements described in section 1616 of that Act or section 212 of P.L. 93-66. To be an eligible employee, the individual must have received SSI payments during a month ending during the 60-day period which ends on the date the individual is hired by the employer. The designated local agency will issue the certification after a determination by the agency making the payments that these conditions have been fulfilled.

(5) *General assistance recipients*.—General assistance recipients are individuals who receive general assistance for a period of not less than 30 days if this period ends within the 60-day period ending on the date the individual is hired by the employer. General assistance programs are State and local programs which provide individuals with money payments based on need. These programs are referred to by a wide variety of names, including home relief, poor relief, temporary relief, and direct relief. Examples of individuals who may receive money payments from general assistance include those ineligible for a Federal program, or waiting to be certified by such a program, unemployed individuals not eligible for unemployment insurance, and incapacitated or temporarily disabled individuals. Some general assistance programs provide needs to those individuals who find themselves in a one-time emergency situation; however, many of these families will not meet the "30-day requirement" described above. Because of the wide variety of such programs, the Congress has provided that a recipient will be an eligible employee only after the program has been designated by the Secretary of the Treasury, after consultation with the Secretary of Health, Education, and Welfare, as a program which provides cash payments to needy individuals. Certification will be performed by the designated local agency.

(6) *Cooperative education students*.—The sixth target group consists of youths who actively participate in qualified cooperative education programs, who have attained age 16 but who have not attained age 19, and who have not graduated from high school or vocational school. The definitions of a qualified cooperative education program and a qualified school are similar to those used in the Vocational Education Act of 1963. Thus, a qualified cooperative education program means a program of vocational education for individuals who, through written cooperative arrangements between a qualified school and one or more employers, receive instruction, including required academic instruction, by alternation of study in school with a job in any occupational field, but only if these two experiences are planned and supervised by the school and the employer so that each experience contributes to the student's education and employability.

For this purpose a qualified school is (1) a specialized high school used exclusively or principally for the provision of vocational educa-

tion to individuals who are available for study in preparation for entering the labor market, (2) the department of a high school used exclusively or principally for providing vocational education to persons who are available for study in preparation for entering the labor market, or (3) a technical or vocational school used exclusively or principally for the provision of vocational education to persons who have completed or left high school and who are available for study in preparation for entering the labor market. In order for a nonpublic school to be a qualified school, it must be exempt from income tax under section 501(a) of the Code. In the case of individuals in this group, wages paid or incurred by the employer are taken into account only if the school certifies that the wages are attributable to services performed as an integral part of the program, while the individual is enrolled in and actively pursuing the qualified cooperative education program and that the individual is age 16 through 18, and not a vocational or high school graduate.

(7) *Economically disadvantaged former convict.*—Any individual who is certified by the designated local employment agency as having at some time been convicted of a felony under State or Federal law and who is a member of an economically disadvantaged family is an eligible employee for purposes of the targeted jobs credit, if such individual is hired within five years of the later of release from prison or date of conviction. The definition of an economically disadvantaged family and the procedures for certifying to the employer that an individual is a member of such a family are the same as those discussed above.

#### *Limitation on amount of qualified wages*

To prevent the hiring of targeted employees from displacing a substantial number of non-targeted employees, the Act provides that qualified first-year wages during a taxable year cannot exceed 30 percent of aggregate FUTA wages for all employees during the calendar year ending in that taxable year. FUTA wages are the first \$6,000 of wages per employee per calendar year. While for a taxpayer whose taxable year does not end in a calendar year, this limitation does not permit a perfect match between the qualified first-year wages of targeted employees and the wages of all employees, the percentage is believed to be sufficiently high to compensate for whatever mismatch is likely to occur between time periods as a result of comparing taxable year wages with calendar year wages. This limitation is much simpler than the incremental limitation which previously applied under prior law to the extra credit for vocational rehabilitation referrals.

Special rules are provided for certain agricultural and railroad employers not covered by FUTA. These rules are similar to those in effect under prior law for the new jobs credit and allow these employers to use their records under the social security tax (FICA) and the Railroad Unemployment Insurance Act (RUIA), respectively.

#### *Definition of wages*

Wages eligible for the credit are defined by reference to the definition of wages under FUTA, in section 3306(b) of the Code, except that the dollar limits do not apply. Special rules, similar to those referred to in the previous paragraph, are provided for certain agricultural and railroad employers.

The Act provides the credit only for employees of a trade or business of the employer. This provision excludes, for example, maids, chauffeurs, and other household employees. The Act does not allow a credit unless more than half the employee's wages are for services in the employer's trade or business. The test as to whether more than one-half of an employee's wages are for services in a trade or business is applied to each separate employer, without treating related employers as a single employer. (See discussion under *Other rules*, below.)

### *Other rules*

In order to prevent taxpayers from escaping all tax liability by reason of this credit, the amount of the credit may not exceed 90 percent of the taxpayer's income tax liability. Furthermore, the credit is allowed only after all other nonrefundable credits have been taken. If, after applying all other nonrefundable credits, 90 percent of a person's remaining tax liability for a year is less than the targeted jobs credit, the excess credit can be carried back three years and carried forward seven years, beginning with the earliest year.

The Act retains several provisions of the prior new jobs credit which are relevant to the targeted jobs credit. Thus, all employees of all corporations that are members of a controlled group of corporations are to be treated as if they were employees of the same corporation for purposes of determining the years of employment of any employee, wages for any employee up to \$6,000, and the 30-percent FUTA cap. Generally, under the controlled group rules, the credit allowed the group is the same as if the group were constituted as a single company. A comparable rule is provided in the case of partnerships, proprietorships, and other trades or businesses (whether or not incorporated) which are under common control, so that all employees of such organizations generally would be treated as if they were employed by a single person. The amount of targeted jobs credit allowable to each member of the controlled group will be its proportionate share of the wages giving rise to the credit.

On the other hand, several rules which were thought necessary for the general jobs credit were not retained in the Act. The purpose of the targeted jobs credit is to encourage employers to hire employees from certain specifically enumerated groups, the hiring of which the Congress believes is deserving of special incentives. Because the Congress' overriding concern is to provide an incentive for the hiring of employees from these groups, the Act provides for no dollar limitation on the amount of the credit. Also, because most tax shelter activities would not be able to obtain sufficient credits to increase the value of the shelter, the Congress decided not to limit the credit allowed to a partner, shareholder of an electing small business corporation, or beneficiary of a trust or estate to the proportionate part of the tax for the year attributable to the taxpayer's interest in the particular partnership, etc., from which the credit is derived.

### ***Effective date***

The provision was intended to be effective for taxable years beginning after December 31, 1978 for wages paid or incurred before January 1, 1982. However, due to a typographical error, the statutory provision only applies to wages paid before January 1, 1981. The pro-

vision making the credit elective was also intended to be retroactive to taxable years beginning after December 31, 1976. (It is anticipated that corrective legislation will be considered in the 96th Congress with respect to the wage termination date and election of the credit under prior law.)

A transitional rule is included to coordinate the effective date of the targeted credit for 1979 with the expiration of the prior new jobs tax credit at the end of 1978 for fiscal year taxpayers. Under the transition rule a taxpayer with a fiscal year beginning in 1978 will compute his general jobs credit under prior law (but without regard to the 100 percent of tax liability limitation) for wages paid in 1978 and his targeted jobs credit under the Act (also without regard to the 100 percent of tax liability limitation) for wages paid in 1979, add the two credits together and then apply the 100 percent of tax liability limitation. The resulting credit is the amount allowed for that fiscal year.

### ***Revenue effect***

The new targeted jobs credit will reduce budget receipts by \$141 million in fiscal year 1979, \$483 million in fiscal year 1980, and \$86 million in fiscal year 1983. (See Table I-2 for the revenue effect of allowing the existing general jobs credit to expire after 1978.)



## **2. WIN and Welfare Recipient Tax Credits (sec. 322 of the Act and secs. 50A, 50B and 280C of the Code)**

### ***Prior law***

Under the prior work incentive (WIN) tax credit and the associated welfare recipient tax credit, employers could receive a tax credit equal to 20 percent of the wages paid during the first 12 months of employment (whether or not consecutive) to individuals who had received AFDC for at least 90 days or who were placed in employment under the WIN program. The WIN credit was limited to employees of a trade or business, while the welfare recipient credit also was available for up to \$5,000 of nonbusiness wages per taxpayer. The amount of the credit available to any employer was limited to \$50,000 of tax liability plus one-half of tax liability in excess of \$50,000. The WIN credit generally was not available if the employment was terminated without cause within a certain period after the employment started (generally six months), although the welfare recipient credit was available for all employees who had been employed at least 30 days on a substantially full-time basis. In addition, under both credits, wages and benefits could be no less than wages and benefits paid to other employees of the employer for similar jobs, the employee for whose wages the credit was taken could not displace any individual from employment, and the employee could not be a close relative, dependent, or major stockholder of the employer. The welfare recipient credit was to expire January 1, 1980.

### ***Reasons for change***

The Congress believed that employer utilization of the WIN and welfare recipient tax credit was far below what could have been achieved if the rate of the credit had been higher and the rules for claiming it were simpler. Recent evaluation of these tax credits indicated that employers were confused by the different rules under which credits could be claimed for AFDC recipients and WIN registrants and that the prior rate of credit was too low to generate employer interest in hiring welfare recipients, who typically have low levels of education and work experience. Therefore, the Congress decided to amend the WIN and welfare recipient tax credit to increase the rate and simplify the rules which govern employer eligibility for the credits.

### ***Explanation of provision***

The Act amends the provisions of the WIN and welfare recipient credit so that, for trade or business employment, the credit allowed in any taxable year is equal to 50 percent of qualified first-year wages and 25 percent of qualified second-year wages. For employment other than in a trade or business, the credit is 35 percent of qualified first-year wages. Qualified first-year wages consist of wages attributable to service rendered by an eligible employee during the one-year period beginning with the day the individual first begins work for the employer.

Qualified second-year wages consist of the wages attributable to service rendered during the one-year period which begins at the close of the first year described just above. Thus, the date on which the wages are paid does not determine whether the wages are first-year or second-year wages; rather, the wages must be attributed to the period during which the work was performed.

Qualified wages do not include wages paid to employees who were first hired by the employer before September 27, 1978, for services rendered after the one-year period beginning with the date the individual first began work for the employer. However, the employer shall treat eligible employees, who are hired on or after that date, for the purpose of applying the amendments made by this section of the Act, as if they began work for the employer on January 1, 1979, or, if later, the actual date they began work.

No more than \$6,000 of wages during either the first or second year may be taken into account for a year of employment after 1978 with respect to any individual.<sup>1</sup> Thus, the maximum credit per individual employed in a trade or business is \$3,000 in the first year of employment and \$1,500 in the second year of employment. In order to prevent the credit and the ordinary wage deduction from causing a tax reduction greater than the amount of eligible wages, and to make the percentage reduction in labor cost equal for all trade or business employers, regardless of their tax bracket, the Act provides that the ordinary deduction for wages is reduced by the amount of the credit. Thus, for a trade or business employer who hires an eligible employee who earns \$6,000 in his first year of employment, the credit causes an actual reduction in taxes which ranges from \$900 (for an employer in the 70-percent bracket) to \$2,580 (for an employer in the 14-percent bracket).

The Act increases the current limitation of the credit from \$50,000 of tax liability plus 50 percent of tax liability in excess of \$50,000 to 100 percent of tax liability. In addition, the current limitation on eligible wages paid for employment not in a trade or business is increased to \$12,000; this will allow any taxpayer to claim credit for up to two full-time nonbusiness employees. The credit for dependent care expenses may not be claimed with respect to any wages for which the taxpayer is allowed a WIN credit. The separate limitation on wages paid with respect to child day care services is eliminated.

The Act provides that the rules defining an eligible employee and the restrictions on the availability of the credit are the same for AFDC recipients and WIN registrants. Thus, an employee will have to fulfill two conditions in order to make the employer eligible for the credit. First, the employee will be either a member of an

<sup>1</sup> For example, if a trade or business employer with a calendar year taxable year hires a eligible employee on September 1, 1979, and pays him \$2,500 in that taxable year, the employer is eligible for a credit of 50 percent of \$2,500, or \$1,250 in that taxable year. For the next taxable year, the employer is also eligible for a 50 percent credit on the next \$3,500 paid to that employee through August 31, 1980. No credit is allowed on any additional wages paid to that employee through August 31, 1980. However, the employer is eligible for the 25-percent credit on any wages paid to the employee beginning September 1, 1980, until the total wages paid to the employee from that date (through August 30, 1981) equal \$6,000.

AFDC family which has been receiving AFDC at least 90 continuous days immediately preceding the date on which the individual is hired by the taxpayer or must be placed in employment under the WIN program. Second, the employee will have to be employed by the taxpayer in excess of 30 consecutive days on a substantially full-time basis. All rules relating to recapture of the credit, which applied only to WIN registrants, are repealed. WIN registrants, as well as AFDC recipients, will be eligible employees even if employed in nontrade or business activities.

Rules are provided so that all employees of all corporations that are members of a controlled group of corporations are to be treated as if they were employees of the same corporation for purposes of determining the years of employment and the \$6,000 wage limit for an employee. Generally, under the controlled group rules, the credit allowed the group is the same as if the group were constituted as a single company. A comparable rule is provided in the case of partnerships, proprietorships, and other trades or businesses (whether or not incorporated) which are under common control, so that all employees of such organizations generally would be treated as if they were employed by a single person. The amount of credit allowable to each member of the controlled group will be its proportionate share of the wages giving rise to the credit.

The Act provides that the credit is permanent.

Finally, the Act, provides that the WIN-welfare recipient tax credit will not be allowed in the case of: (1) expenses reimbursed by a grant; (2) employees who displace other employees from employment; (3) migrant workers; or (4) employees who are close relatives, dependents, or major stockholders of the employer.

### ***Effective date***

The revised WIN-welfare recipient tax credit generally is effective after December 31, 1978, for taxable years ending after that date. For purposes of applying the amendments made by this section of the Act, eligible employees hired after September 26, 1978, shall be treated as having first begun work for the taxpayer no earlier than January 1, 1979.

### ***Revenue effect***

This provision will reduce budget receipts by \$39 million in fiscal year 1979, \$136 million in fiscal year 1980, and \$264 million in fiscal year 1983.

## **D. TAX-EXEMPT BONDS**

### **1. Industrial Development Bond Provisions**

#### **a. Increase in limit on small issues of industrial development bonds (sec. 331 of the Act and sec. 103(b) of the Code)**

##### ***Prior law***

Interest on State and local government obligations generally is exempt from Federal income taxation. However, interest on State and local government issues of industrial development bonds is taxable, with certain exceptions. A State or local government obligation is an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in a trade or business of a person (unless carried on by a government unit or by certain tax-exempt organizations) and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property used in such trade or business.

An exception to the general rule of taxability of interest on industrial development bonds is provided for certain small issues (sec. 103 (b) (6)). This exception applies to issues in amounts of \$1 million or less, if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property. At the election of the issuer, the \$1 million limitation can be increased to \$5 million. If this election is made, the exception is restricted to projects where the aggregate amount of outstanding exempt small issues and capital expenditures (financed otherwise than out of proceeds of an exempt small issue) made over a six-year period do not exceed \$5 million.

Both the \$1 million and \$5 million limitations are determined by aggregating the face amount of all outstanding related prior issues, plus, in the case of the \$5 million limitation, certain capital expenditures for all facilities used by the same or related principal users which are located within the same county or same incorporated municipality. However, facilities located in a county are not aggregated, for this purpose, with facilities located in incorporated municipalities within that county.

##### ***Reasons for change***

Since the enactment of the small issues exemption in 1968, there has been a substantial decrease in the purchasing power of the dollar. As a result, projects for which the limited small issues exemption from the industrial development bond provisions were intended no longer can qualify. This is particularly so in the case of the \$5 million limitation since all capital expenditures on the project must be counted towards the limitation regardless of the amount financed by tax-exempt bonds. As a result, the Congress believed that the \$5 million small issues exemption should be increased to \$10 million.

In addition, in order to promote economic development in those areas where it is most needed, the Congress believes that the capital expenditure limitation for certain economically distressed areas should be increased to \$20 million.

### ***Explanation of provision***

The Act increases from \$5 million to \$10 million the amount of the limitation on the size of the small issue election for tax-exempt industrial development bonds.

The Act also, in general, increases the capital expenditure limitation for facilities with respect to which an urban development action grant has been made to \$20 million. However, only \$10 million of the funds used to finance an urban development action grant facility may be provided through the use of tax-exempt elective small issue industrial development bonds.

Under the Act, if substantially all the proceeds of an elective exempt small issue industrial development bond are used to provide facilities with respect to which an urban development action grant has been made, then in determining the aggregate face amount of such an issue, capital expenditures in an amount up to \$10 million (financed otherwise than out of the proceeds of an exempt small issue) will not be taken into account. For purposes of this provision, "facilities with respect to which an urban development action grant has been made" means facilities owned by, leased to, or assigned to companies or developers named on an original or amended application for an urban development action grant. However, facilities will not meet the requirements of this provision unless the named companies and developers have received an urban development action grant, that they make a firm financial commitment to an urban development project, and that their commitments bear a clear, direct relationship to the activities for which the grant is being made available.

Further, for purposes of determining the total capital expenditures made or incurred with respect to a facility which qualified for the \$20 million capital expenditure limitation, existing law shall be used to determine whether amounts expended from an urban development action grant are included or excluded expenditures.

### ***Effective date***

The provision increasing the elective small issues limitation to \$10 million applies to bonds issued after December 31, 1978, and to capital expenditures made after December 31, 1978, with respect to obligations issued before January 1, 1979. The provision dealing with urban development action grants applies to obligations issued after September 30, 1979, and to capital expenditures made after September 30, 1979, with respect to obligations issued after that date.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million in fiscal year 1979, \$3 million in fiscal year 1980, and \$37 million in fiscal year 1983.

**b. Local furnishing of electric energy (sec. 332 of the Act sec. 103(b)(4) of the Code)**

***Prior law***

Interest earned on obligations of a State or local government generally is exempt from Federal income tax. This rule does not extend to industrial development bonds, the proceeds of which are used by a tax-paying enterprise in its trade or business, except where the proceeds of the bonds are used for specified exempt purposes, and except for certain small issues.

Although the use of facilities for the local furnishing of electric energy is one specified exempt purpose for industrial development bonds (sec. 103(b)(4)(E)), many bond issues for electric energy facilities cannot qualify for the exemption under current Treasury Department regulations (§ 1.103-8(f)(2)(iii)(d)), which interpret the term "facilities for the local furnishing of electric energy" to mean in general facilities furnishing electric energy to the general populace in a service area comprising no more than two contiguous counties. The regulation also provides that a city will in general be treated as a county if it is not within one or more counties or does not consist of one or more counties.

***Reasons for change***

The current interpretation of the term "local furnishing of electric energy" by the Treasury has prevented the issuance of tax-exempt bonds for financing the construction of facilities to furnish electric energy in service areas which are larger than two contiguous counties. This two contiguous county rule applies even if the service area of an electric energy facility consists of a single city.

The Congress believed it to be appropriate to allow tax-exempt financing of facilities which furnish electric energy to a city. The Congress also concluded that to allow tax-exempt financing of electric energy facilities in such cases is consistent with the current Treasury regulation which in some instances treats a city as a county. However, the Congress also believed, since the purpose of allowing tax-exempt financing of electric facilities is to benefit primarily small communities or small geographic service areas, that when an exception to the two contiguous county rule is made it should be limited to a service area consisting of no more than one city and one contiguous county.

***Explanation of provision***

The Act provides an exception to the general rule that facilities for the local furnishing of electric energy means facilities furnishing electric energy to an area comprising no more than two contiguous counties. Under this exception an electric energy facility will meet the local furnishing requirement where it furnishes electric energy solely within an area consisting of no more than one city and one contiguous county. As a consequence of this provision, the local furnishing

requirement will be met by an electric energy facility if it provides service to an area comprising no more than two contiguous counties, or one city and one contiguous county.

In the implementation of this specific amendment to the Code, a question may arise about the effect of an interconnection with other electric utilities. Congress intends that in the case of a facility added to the local furnishing exception by the amendment, that is, a facility which furnishes electric energy solely within the area consisting of one city and one contiguous county, such a facility will not fail the local furnishing test merely because the facility is interconnected with other facilities. The amendment was not intended to affect the local furnishing rules for other facilities. With respect to a facility covered by the amendment, it is expected that procedures will be developed by the Treasury Department under which it may be demonstrated that the local furnishing requirement has been met notwithstanding the interconnection of the facility with other facilities.

Finally, the provision does not affect the meaning of the term "facilities for the local furnishing of gas."

#### ***Effective date***

The provision applies to taxable years ending after April 30, 1968, but only with respect to obligations issued after that date.

#### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million in fiscal year 1979, \$3 million in fiscal year 1980, and \$23 million in fiscal year 1983.

**c. Industrial development bonds for water facilities (sec. 333 of the Act and sec. 103(b)(4)(G) of the Code)**

***Prior law***

Interest on State and local government obligations is generally exempt from Federal income tax. However, tax exemption is denied to State and local government issues of industrial development bonds, with certain exceptions. A State or local government bond is an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business not carried on by a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property used in a trade or business.

Certain industrial development bonds qualify for tax exemption, where the proceeds of the bonds are used to provide certain exempt activities facilities which include facilities for the furnishing of water if available on reasonable demand to members of the general public (sec. 103(b)(4)(G)).

The Internal Revenue Service has interpreted the exemption for facilities for the furnishing of water as being inapplicable where a substantial amount of the capacity of the facility is committed to the use of a small number of industrial users. The Service's interpretation is premised on the public use requirement of present law and on its view that these industrial users are not members of the general public, but rather, non-exempt persons. See Rev. Rul. 76-494 1976-2 C.B. 26. See also, Rev. Rul. 78-21 1978-3 I.R.B. 3 (January 16, 1978).

***Reasons for change***

The Internal Revenue Service has been reluctant to rule, under prior law, that business users of water may constitute the general public; therefore, the Internal Revenue Service has refused to rule that a facility will meet the public use test where a substantial portion of the water is made available to a limited number of industrial users. The Congress believes that business users are also members of the general public and that their use of a facility can satisfy the public use test provided the facility is public in the sense that it makes available a substantial portion of its overall supply of water to residential users in its service area.

In addition, the Internal Revenue Service has interpreted prior law as not permitting a governmental unit to finance a portion of its water lines or other water facilities with tax exempt bonds unless the segment itself serves the public, notwithstanding that it may be part of an overall facility operated by the governmental unit which serves the general public in its service area. The Congress believes the public use test is satisfied if the system (of which the segment being financed



in a part) serves the general public, provided the segment in question is a facility for the furnishing of water and not a production facility, and provided the segment is operated by a governmental unit or a regulated public utility as a part of its overall system.

### ***Explanation of provision***

The Act provides that interest is tax-exempt on industrial development bonds which are used to provide facilities for the furnishing of water for any purpose if the water is or will be made available to the general public and the facility is operated by a governmental unit or a regulated public utility.

Generally, in order for a bond to be eligible for tax-exempt status under the Act, the facility must meet three requirements. It must be for the furnishing of water, it must be operated by a governmental unit or regulated public utility, and it must make available water to members of the general public.

The first requirement under the Act is that a facility is in fact a facility for the furnishing of water and not a production facility. In order to satisfy this requirement, a facility must be a component of a system or project which furnishes water. Ordinarily, a system or project would include only those components necessary for the collection, treatment and distribution of water to a service area, and any other functionally related and subordinate components. Thus, a facility will not constitute a facility for the furnishing of water if the facility uses the water in its own production process. For example, the internal water facilities of a private plant or a cooling pond would not constitute a facility for the furnishing of water or property functionally related and subordinate to such a facility.

In addition, in determining whether a facility is a component of a system or project which furnishes water, a facility shall be viewed in conjunction with its affiliated system or project. In general, a reservoir and its functionally related and subordinate components will constitute a single system. On the other hand, a series of dams will not, in general, constitute a single system, but rather a series of individual systems. Thus, in order for a facility affiliated with one of these dams to qualify under the Act, the system (dam) must be one which furnishes water and the individual facility must be a component of the qualifying system.

Further, the fact that an electric utility is a customer of a governmental unit or a regulated public utility which operates facilities for the furnishing of water does not, in general, transform those water facilities into facilities for the furnishing of electric energy. Thus, a reservoir or dam would not be denied tax-exempt financing merely because one of the uses of the water is for the production of electricity. If substantially all of the water is used for other purposes in addition to the production of electricity, tax-exempt financing may be allowed to the extent the facility qualifies as a facility for the furnishing of water. However, tax-exempt financing will not be allowed for those portions of a dam or reservoir which relate to the production of electricity (such as for generators and turbines) under this provision. In order for such facilities (electric facilities) to qualify for tax-exempt financing, they must meet the requirements of section 103(b)(4)(E) or section 103(d).

The second requirement under the Act is that the facility be operated by a governmental unit or a regulated public utility. In order for a facility to meet the operation test, it must in fact be operated by a governmental unit or a regulated public utility (i.e., the governmental unit or regulated public utility must bear the cost of and be in control of maintenance and repairs of the facility). For example, if a facility is leased to an industrial user on a long-term basis, and the industrial user bears the cost of, or controls maintenance and repair of, the facility, then the facility is not considered to be operated by a governmental unit or a regulated public utility.

The third requirement under the Act is that the water is, or will be, made available to the general public. The general public is not limited merely to residential users or municipal water districts; it also includes electric utility, industrial, agricultural, or other commercial users within the facility's service area.

In order to satisfy the third requirement of the provision, a facility cannot in general deny access to water to residential users or municipal water districts within its service area. However, because electric utility, industrial, agricultural, and commercial users also are members of the general public, a facility does not have to satisfy the water needs of all the residential users in its service area, provided it makes available a substantial portion of its overall supply of water to residential users in its service area. Generally, 25 percent of a facility's capacity may be considered a substantial portion for purposes of this provision. For example, where a reservoir is originally built to serve a single industrial user and the industrial user agrees to "take or pay" for the entire capacity of the reservoir (but is guaranteed only 25 to 75 percent of the capacity), the facility will meet the availability test if the remainder of the water will be offered to residential users.

However, water is not made available to residential users merely because it is available for their recreational use. Thus, a reservoir which denies access to water to residential users except for swimming, water skiing, etc., will not be considered to make water available to members of the general public.

In addition, a facility does not have to make water available to all nonresidential classes of the general public. For example, a reservoir that provides water to residential and industrial users is nonetheless eligible for tax-exempt financing even though the reservoir does not also furnish water for agricultural or irrigation purposes.

Additionally, in determining whether water is or will be made available to members of the general public, a particular facility is to be viewed as a whole. Thus, if a water transmission system consisting of a main system of canals and pipelines and connecting lines serving individual industrial users and municipal water districts is extended to serve only one or two industrial users, the extensions will satisfy the availability test since the system as a whole serves the general public.

Finally, under the provision, there is no requirement that a water facility serve the general public immediately after it is constructed. It is sufficient that the facility is available to serve the general public and that the general public has an opportunity to take water from the pipeline. For example, where a pipeline is built to serve a region

that is sparsely inhabited because of lack of water, there is no requirement that the pipeline serve the general public immediately after it is completed. It is sufficient that the pipeline will serve the general public that, attracted by a new source of water, moves into the region.

***Effective date***

The provision applies to obligations issued after November 6, 1978.

***Revenue effect***

This provision will reduce budget receipts by less than \$1 million in fiscal year 1979, \$7 million in fiscal year 1980, and \$78 million in fiscal year 1983.

**d. Advance refunding of industrial development bonds for certain public works (sec. 334 of the Act and sec. 103(b) of the Code)**

***Prior law***

Interest on State and local government obligations is generally exempt from Federal income tax. However, tax exemption is denied to State and local government issues of industrial development bonds, with certain exceptions. A State or local government bond is an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property, or borrowed money, used in a trade or business.

Certain industrial development bonds qualify for tax exemption, where the proceeds of the bonds are used to provide facilities for certain exempt activities. Such facilities include convention and trade show facilities (sec. 103(b)(4)(C)), airports, docks, wharves, and facilities for mass commuting, parking, or storage and training directly related to these installations (sec. 103(b)(4)(D)).

In general, in order for a facility to qualify as an exempt activity facility, the facility must satisfy a public use requirement; that it serves or is available on a regular basis for general public use or is a part of a facility so used. (Sec. 1.103-8(a)(2) Treas. Regs.) Transportation facilities will in general satisfy the public use requirement by being available for use by members of the general public or for use by common carriers or charter carriers which serve members of the general public. (Sec. 1.103-8(e)(1) Treas. Regs.) Further, a dock or wharf which is part of a public port satisfies the public use requirement. (Sec. 1.103-8(e)(1) Treas. Regs.) Convention and trade show facilities will in general satisfy the public use requirement by being available for an appropriate charge or rental for use by members of the general public. On the other hand such facilities will not satisfy the public use test where use is limited by long-term leases to a single user or group of users. (Sec. 1.103-8(d)(1) Treas. Regs.)

Prior to December 1977, if an issue of industrial development bonds qualified as a tax-exempt bond, a refunding issue<sup>1</sup> of that issue may have also qualified as a tax-exempt bond. However, under proposed regulations issued December 6, 1977, advance refunding issues

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<sup>1</sup> In general, refunding issues are bonds of which the proceeds are used to redeem outstanding bonds. Refunding issues are issued typically to take advantage of lower current interest rates, or to remove restrictive covenants in the original bond issue. Advance refunding issues are bonds issued prior to the maturity date of the original bond. In an advance refunding of tax-exempt industrial development bonds both the original issue and the refunding issue remain outstanding, thereby significantly increasing the amount of tax-exempt bonds outstanding for any project.

for industrial development bonds that are issued more than 180 days before the original issue is redeemed do not qualify as tax-exempt bonds.

The Treasury proposed this amendment to the refunding regulations because it believed that their issuance contravenes the statutory requirement that substantially all of the proceeds of an industrial development bond must be used to provide a facility described in the statute in order to qualify for tax exemption. The Treasury further believes that advance refunding issues violate this requirement, since they permit the issuance of a face amount of tax-exempt bonds which when aggregated with the outstanding issue exceed the cost of a given facility commencing with the issuance of the refunding issue and ending with the call or retirement of the original issue.

### ***Reasons for change***

The general purpose of this provision is to distinguish between advance refunding of obligations used to provide public facilities and private facilities. The Congress believes that State and local governments should be allowed to advance refund industrial development bonds used to provide certain types of public facilities. Although advance refunding in general increases borrowing costs and increases the amount of tax-exempt bonds outstanding for any project, the Congress believes that, where the refunded issue was used to provide certain facilities which are generally available for use by the general public, it is appropriate to allow State and local governments to advance refund where the refunding will result in the removal of unfavorable conditions in the original bond issue or will result in debt service savings.

However, because advance refunding tends to increase the total outstanding tax-exempt bonds, the Congress has decided not to allow the advance refunding of bonds used to provide essentially private facilities. The refunding bonds, which are essentially private, it is argued compete with true municipal debt for a share of the tax-exempt market, thus increasing the costs of financing public facilities.

### ***Explanation of provision***

The Act allows advance refunding of certain outstanding tax-exempt industrial development bonds. Interest on an advance refunding issue of an industrial bond is tax-exempt only if substantially all the proceeds of the refunded issue will be used to provide a qualified public facility. Qualified public facilities are defined as airports, docks, or wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to these facilities, and convention or trade show facilities which are generally available to the general public.

The Act, in general, applies only to the advance refunding of industrial development bonds substantially all the proceeds of which were used to provide transportation and convention and trade show facilities which directly serve or are available on a regular basis for general public use. Facilities which qualify as exempt activities facilities because they are available for use by common carriers or charter carriers which serve members of the general public will not be considered qualified public facilities for purposes of this provision unless such facilities directly serve the general public or are available on a

regular basis for the general public use. Further, facilities which are part of a qualified public facility will not be considered qualified public facilities unless such facilities directly serve the general public or are available on a regular basis for general public use.

Thus, a facility which is part of a qualified public facility (e.g., a hangar, a repair facility, a wharf, or a dock) which is owned by a nonexempt person, or leased to or assigned to a nonexempt person permanently or for the major portion of its useful life, will fail the availability test if the facility does not provide services to the general public (e.g., repair or storage services for all airplanes) or is not available on a regular basis for general public use. On the other hand, a facility which is owned by a governmental unit shall be considered to be available to the general public, if it is leased to or assigned to a nonexempt person on a short-term basis, provided that the facility will be available to the general public for the major portion of its useful life.

Notwithstanding the above, a tax-exempt industrial development bond used to provide a facility which is not a qualified public facility may in certain instances be advance refunded in a multipurpose issue.

The Act also prohibits the advance refunding of an advance refunding issue where a prior issue is still outstanding. Thus, no more than two tax-exempt issues will be outstanding for any one project at the same time.

The Act applies to refunding obligations issued after the date of enactment. For example, if industrial development bonds were issued in 1967 and substantially all the bond proceeds were used to provide a qualified public facility, then tax exempt advance refunding of the 1967 bonds will be allowed so long as the refunding obligations are issued after the date of enactment.

The Act is not intended to affect (by implication or otherwise) the tax treatment of the advance refunding of general obligation or general revenue municipal bonds which are legal obligations of the issuing government.

### ***Effective date***

The provisions applies to refunding obligations issued after November 6, 1978.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million annually.

## **2. Other Tax-Exempt Bond Provisions**

### **a. Declaratory judgment procedure for judicial review of determinations relating to governmental obligations (sec. 336 of the Act and new sec. 7478 of the Code)**

#### ***Prior law***

Interest on State and local obligations is generally tax-exempt. However, tax-exempt status is denied to industrial development bonds (section 103(b) of the Code) and arbitrage bonds (section 103(c) of the Code).

Although it is not necessary for the issuer of State and local bonds to obtain a determination as to the tax status of a bond issue, as a practical matter, if an issue is seemingly in conflict with any ruling or regulations published by the Internal Revenue Service, it cannot be marketed. This is the case, regardless of the validity of the Service's ruling or regulations.

In addition, a bond issue may not be marketable due to uncertainty as to whether it is issued by a State or local government within the meaning of section 103(a), e.g., whether the obligations are issued by an authority "on behalf of" a State or local government.

#### ***Reasons for change***

Under prior law, an issuer had no appeal from an Internal Revenue Service private letter ruling (or failure to issue a private letter ruling) that a proposed issue of municipal bonds is taxable. In those cases, although there may be a real controversy between a State or local government and the Service, prior law did not allow the State or local government to go to court. The controversy could be resolved only if the bonds were issued, a bondholder excluded interest on the bonds from income, the exclusion was disallowed, and the Service asserted a deficiency in its statutory notice of deficiency. This uncertainty coupled with the threat of the ultimate loss of the exclusion, invariably makes it impossible to market the bonds. In addition, it was impossible for a State or local government to question the Service rulings and regulations directly.

The Congress believes that a State or local government should have a right to court adjudication in the situation described above. The Act deals with the problem by providing that, in the event of an unfavorable private letter ruling (or failure to issue a ruling), the State or local government may ask the United States Tax Court for a declaratory judgment as to the tax status of a proposed issue of municipal bonds.

#### ***Explanation of provisions***

##### ***In general***

The Act provides that the United States Tax Court is to have exclusive jurisdiction in the case of an actual controversy involving a de-

termination (or failure to make a determination) by the Internal Revenue Service as to whether interest on a prospective obligation is exempt from Federal income taxation. For purposes of this provision, a prospective obligation means an obligation (whether an original issue or a refunding issue) which has not been issued at the time a petition seeking a declaratory judgment is filed with the Tax Court. A suit under this provision can be brought only by the prospective issuer which has sought a determination regarding the tax-exempt status of its proposed issue.

While this new declaratory judgment procedure is being made available to State and local governments that desire to use it, there is no requirement that they use this new procedure to determine the tax status of municipal bonds. Further, the Act imposes no requirement that a request for a private letter ruling be made as a condition for tax exemption.

In order to satisfy the court that an actual controversy exists, a prospective issuer will have to adopt a bond resolution, or take such other required action as may be necessary, in accordance with State or local law authorizing the issuance prior to the time it files a petition with the Tax Court. However, the bond resolution may be contingent on a favorable determination.

The Tax Court is to have jurisdiction to make a declaration as to whether interest on an obligation is exempt from Federal income taxation. Any such declaration is to have the force and effect of a final judgment or decree and is to be reviewable as such. While it is anticipated the Tax Court will expedite resolution of these cases, such treatment will be at the discretion of the Tax Court so as not to restrict the Court's flexibility in handling the remainder of its caseload.

The Court is to base its determination upon the reasons provided by the Internal Revenue Service in its notice to the party making the request for a determination and on any other facts or arguments which the Service and/or the proposed issuer wish to introduce at the time of trial. However, any such facts or arguments must be relevant to the issues raised in the administrative record. Neither party may raise new issues at the time of trial. Of course, if an unfavorable determination is based on a published ruling or regulation (including a proposed regulation), the court may rule on the validity of the published ruling or regulation.

A judgment in a declaratory judgment proceeding is to be binding upon the parties to the case, and is to foreclose future legal action by them to redetermine the tax status of the bonds.

#### *Exhaustion of administrative remedies required*

For a proposed issuer to receive a declaratory judgment under this provision, it must demonstrate to the court that it has exhausted all published administrative remedies which are available to it within the Internal Revenue Service for a private ruling letter, that the Internal Revenue Service has either failed to act or has acted adversely, and that it has exhausted its right to appeal any adverse determination. Moreover, to exhaust its administrative remedies, a proposed issuer must satisfy all procedural requirements of the Service relating to municipal bond rulings. For example, the Service may decline to issue a private letter ruling if a State or local government fails to supply



the Service with the necessary information on which to make a determination.

A proposed issuer is not to be deemed to have exhausted its administrative remedies in cases where the Internal Revenue Service has failed to make a determination before the expiration of 180 days after a request (complying with the procedural requirements of the Internal Revenue Service) for such a determination was made. Once this 180-day period has elapsed, a proposed issuer that exhausted its remedies may bring an action even though no private letter ruling has been issued by the Internal Revenue Service.

Of course, if the Service makes a determination during this 180-day period, then the proposed issuer need not wait until the end of the 180-day period to initiate the declaratory judgment proceeding. However, no action for declaratory judgment may be filed after 90 days from the date on which the Secretary or his delegate sends notice to a person of a private letter ruling (including refusals to issue such a ruling) as to the tax status of the bonds.

#### *Tax Court Commissioners*

In order to provide the Tax Court with flexibility in carrying out this provision, the Act authorizes the Chief Judge of the Tax Court to assign the commissioners of the Tax Court to hear and make determinations with respect to petitions for a declaratory judgment, subject to such conditions and review as the Court may provide, by an appropriate rule, directive, or order, whether or not published.

#### ***Effective date***

These provisions apply in general to requests for determinations filed with the Internal Revenue Service after December 31, 1978. The provisions also apply to requests for determinations filed prior to December 31, 1978, which are withdrawn and refiled after December 31, 1978.

#### ***Revenue effect***

This provision is not expected to have any revenue effect.

**b. Disposition of amounts generated by advance refunding of certain government obligations (sec. 337 of the Act)**

***Prior law***

Under section 103 of the Code, interest on obligations of State and local governments generally is exempt from Federal income tax. Prior to 1969, State and local governments were able to invest the proceeds of their tax exempt obligations in higher yielding taxable obligations (usually U.S. Treasury bonds) thereby earning an arbitrage profit. In 1969 the tax-exempt status of arbitrage bonds was withdrawn. Arbitrage bonds were defined as bonds all or a major portion of the proceeds of which are invested in materially higher yielding securities or are used to replace funds which were used directly or indirectly to acquire higher yielding securities.

In order to comply with the yield restrictions on obligations acquired with the proceeds of their obligations, some State and local governments purchased taxable bonds at a premium. This has had the effect of reducing the effective yield on the acquired obligation and creating an arbitrage or windfall profit for the seller of the obligation. Typically, the windfall profit created from the payment of a premium would go either to the bond broker selling the acquired obligation, or would be diverted to charity. Where the charity performed functions which the issuer would otherwise perform, the benefit to the issuer arguably constituted a prohibited return on the investment of its bond proceeds.

On September 24, 1976, the Treasury Department announced proposed regulations which would affect bonds issued after that date. The proposed regulations provided that in determining whether the yield on obligations acquired with the proceeds of a refunding issue is materially higher than that of the refunding issue, the market price of the acquired obligation as determined by reference to an established market shall be used. The effect of these regulations is to prevent issuers from diverting arbitrage profits (or windfall) to underwriters or other third parties. Although the regulations, by their terms, apply prospectively only, the Internal Revenue Service rulings policy has been to apply the regulations retroactively.

***Reasons for change***

Prior to the release of the proposed regulations, many persons had spent considerable money, time and effort in preparation of refunding various tax-exempt obligations. In certain situations the refunding plan contemplated that the windfall profit would be paid to a charity.

In view of the circumstances, the Congress believes that it is unfair and inequitable to apply these regulations retroactively where the arbitrage profits would go to charity.

### ***Explanation of provision***

The Act, in general, prohibits the Treasury from applying the position taken by the regulations retroactively to prevent arbitrage profits from being donated to a public charity.

Under the Act, payment of a refund profit to a charitable organization in accordance with a qualified agreement shall not cause the refunding obligation (which gave rise to the refund profit) to be treated as an arbitrage bond or cause the imposition of any penalty upon the issuer ("blacklisting") if certain conditions are met. First, the refund profit (arbitrage profit) must have been generated by or arisen out of an advance refunding of a tax-exempt State or local government obligation which occurred before September 24, 1976. Second, the refund profit (arbitrage profit) must be held (1) in a trust fund, (2) in an escrow account, or (3) by an underwriter or other person, under a qualified agreement. Finally, such an agreement must provide for, or contemplate, the payment of the refund profit to one or more organizations described in section 501(c)(3) and exempt from taxation under section 501(a) (other than an organization described in sec. 509(a)).

In addition, where a State or local government has accounted to the United States for the refund profit by direct payment or by purchase of low-interest United States obligations because of the Internal Revenue Service's rulings policy, the Treasury shall return such accounted-for refund profits, which within 90 days of receipt by the State or local government shall be given to the intended beneficiary. Repayment by the Treasury shall be required under the Act, only if on or before January 1, 1977, the State or local government which entered into a qualified agreement requested, in writing, a ruling from the Internal Revenue Service on the tax consequences of paying refund profits to charitable organizations and failed to receive a favorable ruling, and did not pay the refund profit to a charitable organization. The repayment shall be paid out of any amounts in the Treasury not otherwise appropriated.

### ***Effective date***

The effective date of this provision is November 6, 1978.

### ***Revenue effect***

This provision will not have any revenue effect.

## **E. SMALL BUSINESS CORPORATION PROVISIONS**

### **1. Small Business Corporations (Subchapter S)**

#### **a. Subchapter S corporation allowed 15 shareholders (sec. 341 of the Act and sec. 1371 of the Code)**

##### ***Prior law***

Subchapter S was enacted in 1958 in order to minimize the effect of Federal income taxes on the form in which a business is conducted by permitting incorporation and operation of certain small businesses without the incident of income taxation at both the corporate and shareholder levels. The subchapter S rules allow a corporation engaged in an active trade or business to elect to be treated for income tax purposes in a manner similar to that accorded partnerships. Where an eligible corporation elects under the subchapter S provisions, the income or loss (except for certain capital gains) is not taxed to the corporation, but each shareholder reports a share of the corporation's income or loss each year in proportion to his share of the corporation's total stock. Once made, the election continues in effect for the taxable year and subsequent years until it is revoked or terminated.

Under prior law, in order to be eligible for a subchapter S election, the corporation generally must have had 10 or fewer shareholders. After a corporation had been an electing subchapter S corporation for 5 consecutive taxable years, it may have increased its number of qualifying shareholders to 15. In addition, the number of shareholders may have exceeded 10 (but not 15) where the additional shareholders acquired their stock through inheritance.

##### ***Reasons for change***

The Congress believes that increasing the permitted number of shareholders to 15 in all situations will simplify existing law by deleting the conditions under which a small business corporation may increase its permitted number of shareholders from 10 to 15. This change will facilitate the use of the subchapter S provision by certain closely-held businesses.

##### ***Explanation of provision***

Under the Act, the number of shareholders permitted in order for a corporation to qualify for and maintain subchapter S status is increased from 10 to 15.

##### ***Effective date***

The provision applies to taxable years beginning after December 31, 1978.

##### ***Revenue effect***

This provision will have a negligible effect on revenues.

**b. Permitted shareholders of subchapter S corporation (sec. 342 of the Act and sec. 1371 of the Code)**

***Prior law***

For purposes of determining the maximum number of shareholders a corporation may have in order to be eligible for a subchapter S election, prior law provided that stock which is community property of a husband and wife (or the income from which is community property income) under the law of a community property State was to be treated as owned by one shareholder. Similarly, a husband and wife were treated as one shareholder where they owned the stock as joint tenants, tenants in common, or tenants by the entirety.

Also, a surviving spouse and the estate of a deceased spouse (or the estates of both deceased spouses) were treated as one shareholder where the husband and wife were treated as one shareholder at the time of the death of the deceased spouse.

***Reasons for change***

The Congress believes that a husband and wife (or their estates) should only be counted as one shareholder for purposes of determining the number of shareholders in a small business corporation without regard to the manner in which the stock is owned by the married couple.

***Explanation of provision***

Under the provision, a husband and wife (and the estates of the husband and the wife) are to be treated as one shareholder for purposes of determining the number of shareholders in a corporation in order to determine if it is eligible to qualify as an electing small business corporation.

The provision also clarifies existing law by providing that the grantor of a grantor trust is treated as the shareholder, rather than the trust, for purposes of determining whether the corporation qualifies as a small business corporation.

***Effective date***

The provision applies to taxable years beginning after December 31, 1978.

***Revenue effect***

This provision will have a negligible effect on revenues.

**c. Extension of period for making subchapter S elections (sec. 343 of the Act and sec. 1373(c) of the Code)**

***Prior law***

Prior law required that in order for a subchapter S election to be effective for a taxable year, it must be filed during a 2-month period which begins 1 month before the start of the taxable year. (For example, if a calendar year corporation wishes to elect subchapter S effective for 1978, the election must be filed during December of 1977 or January of 1978.) An election is not valid for either the intended year or any future year if it is not filed within this period. Extensions of time for filing the election are not granted. Rev. Rul. 60-183, 1961-1 C.B. 625. If an election is found to be untimely upon audit several years later, the corporation is taxed as a regular corporation for all the intervening years, *Opine Timber Co., Inc.*, 64 T.C. 700 (1975); *Joseph W. Feldman*, 47 T.C. 329 (1966).

In effect, the period of time during which an election could be made by a newly-formed corporation for its first taxable year was only one month since a new corporation cannot make the election until it is in existence under State law, which generally occurs at the same time as the beginning of its first taxable year. *J. William Frentz*, 44 T.C. 485 (1965), *aff'd*, 375 F.2d 662 (6th Cir. 1967). In other situations, it was difficult to determine when the 1-month period begins for a new corporation because of several alternative rules used to determine when its first taxable year begins.

***Reasons for change***

In many instances, an apparent timely subchapter S election may be invalid because the election was not filed within the limited period of time allowed under present law. In the case of a new corporation, this problem is particularly acute because of the alternative tests for determining when a corporation begins its existence. An invalid election may affect the shareholders for several years because they may not realize the election is invalid until an audit occurs several years later. In this case, a retroactive election may not be made, and subchapter S status is not available for any of these years.

The limited 2-month rule, applicable to corporations making the election for a year other than the year in which they are formed, was intended to require the corporation to make the election before it could predict its profitability for the year with any certainty. This rule helps preclude use of subchapter S as a tax avoidance mechanism. Extending the period of election to encompass the entire preceding year does not provide any tax avoidance possibilities, and should reduce inadvertent untimely elections by allowing them to be made when they are first considered during the preceding year, rather than having to wait until the last month of the year.

### ***Explanation of provision***

Under the Act, the period of time to make the subchapter S election is expanded to include the entire preceding taxable year of the corporation. In addition, the Act will permit all corporations to make the election during the first 75 days of the taxable year for which the election is effective.

The Act also provides that where the election is made prior to the taxable year for which it is effective, the shareholders who are required to consent to the election are those who hold stock on the day the election is made rather than on the first day of the taxable year for which the election is effective. Where the election is made during the taxable year preceding the year for which it is to be effective, no additional consents will be required where shareholders acquire stock prior to the beginning of the year for which the election is effective. This rule will also apply when an election is not timely filed for the intended taxable year but is effective for succeeding taxable years. In these cases, an individual who becomes a shareholder after the election is filed will have to affirmatively refuse to consent to the election within 60 days of becoming a shareholder to render the election ineffective.

### ***Effective date***

This provision is effective for subchapter S elections made for taxable years beginning after December 31, 1978.<sup>1</sup>

### ***Revenue effect***

This provision will have a negligible effect on revenues.

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<sup>1</sup> A virtually identical provision was enacted by sec. 5 of P.L. 95-628. The effective date of that provision is for elections made after January 9, 1979, in taxable years beginning after that date. Thus, technically the provision in the Revenue Act will apply only to elections for taxable years beginning after December 31, 1978, and before January 10, 1979, and the provision in P.L. 95-628 will apply to taxable years beginning after January 9, 1979. However, the two provisions are identical in substance. In addition, the provision in P.L. 95-628 provides certain retroactive relief.

## 2. Small Business Corporation Stock (sec. 345 of the Act and sec. 1244 of the Code)

### *Prior law*

Under prior law, a gain or loss on the disposition of a capital asset (such as corporate stock held for investment purposes) is either a short- or long-term capital gain or loss depending upon whether the taxpayer's holding period with respect to the capital asset is more than one year. A capital loss sustained by an individual first offsets any capital gain. Any excess capital losses may offset up to \$3,000 of ordinary income. In the case of long-term capital losses which have not been absorbed by short- or long-term capital gains, the amount of loss deductible against ordinary income, subject to the \$3,000 limitation, must be reduced by 50 percent. Capital losses of corporate taxpayers are deductible only to the extent of capital gains.

Ordinary loss treatment, rather than capital loss treatment, is provided in certain cases for small business corporation stock (section 1244 stock) which is disposed of at a loss. This special treatment is accorded only to individual shareholders (not trusts or estates) to whom the stock was originally issued.<sup>1</sup>

The maximum amount of ordinary loss from the disposition of section 1244 stock that may be claimed in any taxable year is limited to \$25,000, except for married taxpayers filing joint returns, in which case ordinary loss treatment is limited to \$50,000.<sup>2</sup> Any loss in excess of the applicable annual limitation is treated as a capital loss.

For stock to qualify as section 1244 stock, eight requirements must be met: (1) the stock must be common stock; (2) the corporation issuing the stock must adopt a written plan under which the stock will be issued and the stock may be offered for sale only during the two-year period beginning with the date of plan adoption; (3) the corporation issuing the stock must be a domestic corporation; (4) the amount of section 1244 stock issued by the corporation may not exceed \$500,000, and the total stock issued plus the equity capital of the corporation may not exceed \$1,000,000; (5) no prior offering of stock of the corporation or any portion of a prior offering of stock may be unissued; (6) the stock must be issued for money or other property, subject to certain excep-

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<sup>1</sup> An individual who is a partner in a partnership would be entitled to this special treatment only if he were a partner in the partnership when the partnership acquired the section 1244 stock and the loss from the disposition of the stock is reflected in his distributive share of partnership items.

<sup>2</sup> Thus, if a married individual files a joint return with his spouse and during the taxable year disposed of section 1244 stock at a loss of \$75,000, only \$50,000 of the loss would be treated as an ordinary loss and the excess of \$25,000 will be treated as a capital loss. Alternatively, if the individual in this example were to have disposed of his section 1244 stock in two taxable years, and if his loss in each of the two taxable years was \$37,500, the loss sustained in each of the two taxable years would be treated as an ordinary loss, because the limitation is determined annually.



tions; (7) more than 50 percent of the gross receipts of the corporation must be derived from the active conduct of a trade or business during the corporation's existence or for its five most recent taxable years prior to the taxable year during which the loss is incurred, whichever period is less;<sup>3</sup> and (8) no subsequent offering of stock, simultaneous with, or subsequent to, the adoption of a plan to issue section 1244 stock may be made.<sup>4</sup>

### ***Reasons for change***

The Congress believes that greater incentives are needed to encourage investment in small business corporations. The dollar limitations for ordinary loss treatment of section 1244 stock issued by a small business corporation were established in 1958. The limits have not been increased to take into account the increased capital needs of smaller business corporations and the effects of inflation. Thus, the Congress believes that increasing the amount of section 1244 stock that qualified small business corporations may issue and increasing the amount of loss treated as ordinary loss by shareholders will assist in providing the capital needed to organize new corporations and to modernize existing plants and equipment.

Additionally, the organizers of many small business corporations that could have issued section 1244 stock have failed to comply with the written plan requirement, thus losing the intended benefits. The Congress believes that the written plan requirement should be eliminated so that issuance of small business stock will not be disqualified either because of an unfamiliarity with the provision or because of the lack of qualified advice upon organization or a subsequent issuance of stock.

### ***Explanation of provision***

In general, the Act increases the amount of section 1244 stock that a qualified small business corporation may issue, repeals the equity capital limitation, increases the amount of loss that certain shareholders may treat as an ordinary loss rather than as a capital loss, and repeals the requirement of a written plan to issue the stock.

The Act increases the amount of section 1244 stock that a qualified small business corporation may issue from \$500,000 to \$1,000,000. The \$1,000,000 limit is determined by reference to the aggregate amount of money and other property received (and to be received) by the corporation (1) for stock, (2) as a contribution to capital, and (3) as paid-in surplus as of the time of issuance of the stock. The value of the property other than money which was (or is to be) received by the corporation for its stock is equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liability to which the property was subject or which was assumed by the corporation. For example, if a qualified small business corporation that was organized after the date of enactment of this provision issues common stock for money amounting to \$600,000, the corporation subsequently may issue additional common stock which qualifies under the provisions of section 1244 in the amount of \$400,000. For this

<sup>3</sup> This requirement must be satisfied at the time of the disposition of the stock.

<sup>4</sup> This requirement must be satisfied both at the time of plan adoption and during the two-year plan period.

purpose, the determination of the \$600,000 amount is to be made at the time that stock was issued, and the determination of the \$400,000 amount to be made at the time that stock was issued.

If a qualified corporation issues common stock the aggregate value of which exceeds \$1,000,000, the Congress intends that the issuing corporation must designate which of the shares of stock issued are to be treated as section 1244 stock. The designation must be made in accordance with regulations to be issued by the Treasury Department.

Under prior law, a domestic corporation was not treated as a small business corporation for purposes of section 1244 unless the aggregate dollar amount to be paid for its stock plus the equity capital (defined as the sum of the corporation's money and other property, such other property taken into account at its adjusted basis for determining gain) less the amount of indebtedness to persons other than shareholders did not exceed \$1,000,000. The Act repeals the equity capital limitation. Thus a corporation, assuming other requirements are met, may issue additional common stock under the provisions of section 1244 without regard to the amount of its equity capital to the extent that the amount received for the common stock to be issued does not exceed \$1,000,000 reduced by the amount received for the stock already issued.

The Act provides for an increase in the maximum amount an individual may treat as an ordinary loss on section 1244 stock for any taxable year. Under the provisions of the Act, the maximum amount that may be treated as an ordinary loss is increased to \$50,000; in the case of a husband and wife filing a joint return for the taxable year in which the loss is incurred, the maximum amount that may be treated as an ordinary loss is increased to \$100,000.

The Act repeals the requirement that a written plan to issue section 1244 stock must be adopted by the issuing corporation. Additionally, the requirement that provides that no prior offering of stock of the corporation or any portion of a prior offering of stock may be unissued at the time a written plan is adopted is not necessary under the Act and also has been repealed. The Act provides that a corporation may issue common stock under the provisions of section 1244 without adopting a written plan, but that only the first \$1,000,000 worth of common stock may qualify as section 1244 stock. If the \$1,000,000 stock limitation is exceeded, the regulations are to provide which portion of the aggregate amount of issued common stock is qualified stock and how such shares of stock are to be distinguished as qualifying stock by both the issuing corporation and its shareholders.

### ***Effective date***

This provision applies to common stock issued after the date of enactment (November 6, 1978).

### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million annually.

## F. FARM ACCOUNTING RULES

### 1. Treatment of Certain Closely-Held Farm Corporations for Accrual Accounting Purposes (sec. 351 of the Act and sec. 447 of the Code)

#### *Prior law*

##### *In general*

A taxpayer is required to use a method of accounting for tax purposes which clearly reflects income (sec. 446). Most taxpayers who are in the business of selling nonfarm products are required to report gross income using an accrual method of accounting and to accumulate their production costs in inventory until the products are sold. However, by reason of administrative rulings issued more than 50 years ago, taxpayers engaged in farming have been allowed to report income and expenses from farm operations on the cash method of accounting, which does not require the accumulation of inventory costs. Except for special capitalization rules applicable to citrus and almond groves, farmers also have been allowed to deduct the cost of seed and young plants purchased in one year which are intended to be sold as farm products in a later year.<sup>1</sup> In addition, administrative rulings have permitted farmers to deduct currently many of the costs of raising farm assets (such as costs related to breeding animals, orchards, and vineyards) which are used in the trade or business of farming. (In non-farming businesses, such as manufacturing, similar costs generally are treated as capital expenditures and are depreciated over the useful lives of the assets acquired.) The special farming tax rules discussed above are still generally applicable to most farmers, although some restrictions were imposed on certain farming corporations and farming syndicates by the Tax Reform Act of 1976.

Also, under the accrual method of accounting as applied to farming, if crops are harvested and unsold at the end of the taxable year, the costs attributable to such crops cannot be deducted in the taxable year but must be treated as inventory. However, even under the accrual method, it had been a long-standing Treasury position to permit a farmer to deduct expenses paid in the taxable year so long as the crops to which these expenses related were unharvested at the end of the taxable year.<sup>2</sup> In 1976, the Internal Revenue Service reversed this long-standing position and ruled that an accrual method taxpayer engaged in farming is required to inventory growing crops (unless the tax-

<sup>1</sup> However, a farmer has not been allowed to deduct the purchase price of livestock, such as cattle which he intends to fatten for sale as beef.

<sup>2</sup> I.T. 1368, I-1 C.B. 72 (1922).

payer uses the crop method of accounting).<sup>3</sup> The effective date of this ruling has been postponed so that it applies only to taxable years beginning on or after January 1, 1978.<sup>4</sup>

### *1976 Act*

With certain exceptions, the Tax Reform Act of 1976 required corporations (and partnerships in which non-excepted corporations are partners) engaged in farming to use an accrual method of accounting and to capitalize preproductive period expenses (sec. 447). However, subchapter S corporations, family corporations (in which one family owns at least 50 percent of the stock), corporations with annual gross receipts of \$1 million or less, and nurseries are not required to use an accrual method of accounting or to capitalize preproductive period expenses.<sup>5</sup>

A taxpayer who is required to change to an accrual method of accounting (or to revise his accrual method of accounting to capitalize preproductive period expenses) pursuant to the 1976 Act is generally allowed to spread the accounting adjustments required by the change in method over a period of ten years.<sup>6</sup>

The 1976 Act provisions generally are effective for taxable years beginning after December 31, 1976. However, the Tax Reduction and Simplification Act of 1977 postponed the effective date of the required accrual accounting provision until taxable years beginning after December 31, 1977, for any farm corporation if, as of October 4, 1976 (the date of enactment of the 1976 Act), either (a) two families owned at least 65 percent of the stock; or (b) three families owned at least 50 percent of the stock and substantially all of the rest of the stock was owned by employees, their families, or exempt pension, etc., trusts for the benefit of the employees.

<sup>3</sup> Rev. Rul. 76-242, 1976-1 C.B. 132. The ruling was to be effective for taxable years beginning on or after June 28, 1976. Under the crop method of accounting, if a farmer is engaged in producing crops, and the process of gathering and disposing of them is not completed in the year in which the crops are planted, the costs of producing, gathering, and disposing of the crops are taken into account in the taxable year the income from the crop is realized. Treas. Reg. § 1.162-12(a).

<sup>4</sup> Rev. Rul. 77-64, 1977-1 C.B. 136. Also, the IRS has recently announced that a taxpayer affected by Rev. Rul. 76-242 could change to the cash method of accounting for the first taxable year beginning on or after January 1, 1978 unless the taxpayer is required to use the accrual method of accounting under section 447 of the Code. Rev. Proc. 78-22, 1978-34 I.R.B. 26, also released as IRS Information Release 2017, July 18, 1978.

<sup>5</sup> The 1976 Act also provides special rules which permit certain corporations to use an "annual accrual method of accounting." An annual accrual method of accounting is a method of accounting under which revenues, costs, and expenses are computed on an accrual method of accounting and the preproductive period expenses incurred during the taxable year are charged to crops harvested during that year or are deducted currently. To be eligible to use this method, a corporation (or its predecessors) must have used this method for a 10-year period ending with its first taxable year beginning after December 31, 1975, and substantially all the crops grown by the corporation must be harvested not less than twelve months after planting.

<sup>6</sup> Prior to the enactment of this Act, section 447(f) gave the Treasury Department broad regulatory discretion to alter this 10-year period. Section 701 (1) (1) of this Act provided more specific rules as to when the adjustments were to be taken into account over shorter periods.

### ***Reasons for change***

In the 1976 Act, which required certain corporations (and partnerships in which certain corporations are partners) engaged in farming to use an accrual method of accounting while allowing other taxpayers engaged in farming to continue to use the cash method of accounting for farming activities, Congress recognized a distinction between large, widely held farming corporations (and sophisticated tax shelter partnerships with corporate general partners) that have the ready access to the skilled accounting assistance which is often required to apply an accrual method of accounting to farming operations and small or family corporations for whom the simpler cash method of accounting was retained.

In general, Congress believes that is desirable to retain the cash method of accounting for certain corporations controlled by two or three families just as it remains available for corporations controlled by one family. These multi-family situations are generally thought to be similar to the situations of corporations controlled by a single family. In addition, the adjustments which would be required to be taken into account (generally over a 10-year period) for an existing corporation may adversely affect the corporation's ability to compete and its financial position.

### ***Explanation of provision***

The Act provides exceptions to the required accrual accounting and capitalization of preproductive period expenses rules (sec. 447) for certain corporations which are controlled by two or three families. Under these exceptions, the provisions requiring accrual accounting and the capitalization of preproductive period expenses will not apply to any farm corporation if, as of October 4, 1976 and at all times thereafter, either (1) two families own (directly or through attribution) at least 65 percent of the total combined voting power of all classes of stock of the corporation entitled to vote and at least 65 percent of the total number of shares of all other classes of stock of the corporation, or (2) (a) members of three families own (directly or through attribution) at least 50 percent of the total combined voting power of all classes of stock entitled to vote and least 50 percent of the total number of shares of all other classes of stock and (b) substantially all of the remaining stock is owned by the corporation's employees (or by their family members within the meaning of sec. 267(c)(4)) or by a tax-exempt employee's trust for the benefit of the corporation's employees.

In order to provide some degree of flexibility in encouraging employee ownership of the corporations, it is provided that, with respect to corporations described in the preceding paragraph, stock acquired from the corporation, or one of the families described above, after October 4, 1976, by the corporation's employees, their families, or a tax-exempt trust for their benefit will be treated as owned by one of the two or three families whose combined stock ownership was used to establish the initial qualification for this provision (as of October 4, 1976). No similar rule is applicable for purposes of the one-family exception of present law.

Since this provision is intended to preserve the use of the cash method of accounting only for certain corporations that were engaged in farming as of the date of enactment of the 1976 Act, the provision contains an additional limitation which requires that eligible corporations must have been engaged in the trade or business of farming on October 4, 1976, and at all time thereafter. The purpose of this requirement is to prevent organizations which had the appropriate stock ownership as of that date but were not engaged in farming to subsequently engage in farming and qualify for this special exemption.

***Effective date***

The provision applies to taxable years beginning after December 31, 1977.

***Revenue effect***

This provision will reduce budget receipts by less than \$5 million per year.

## 2. Accounting for Costs of Growing Crops (sec. 352 of the Act)

### *Prior law*

In general, prior to 1976, farmers, nurserymen, and florists were not required to inventory growing crops. In the case of taxpayers engaged in farming, the Internal Revenue Service, in administrative rulings issued more than 50 years ago, has allowed the use of the cash method of accounting for reporting of income and expenses from farm operations. This method of accounting does not require the accumulation of inventory costs, and, therefore, farmers have been allowed to deduct the cost of seed and young plants purchased in one year which are intended to be sold as farm products in a later year. Also, under the accrual method of accounting as applied to farming, if crops are harvested and unsold at the end of the taxable year, the costs attributable to such crops cannot be deducted in the taxable year but must be treated as inventory. However, even under the accrual method, it had been a long-standing Treasury position to permit a farmer to deduct these expenses in the taxable year when paid so long as the crops to which these expenses related were unharvested at the end of the taxable year.<sup>1</sup>

Similarly, the Internal Revenue Service ruled that nurserymen on the accrual method of accounting could inventory their young trees only where they had reached a marketable size and stage of development and where the market value was definitely known. Also, the Internal Revenue Service has held that florists are not required to use inventories of growing plants for the purpose of calculating their net income for Federal income tax purposes and should not compute the costs of goods sold during the year by using an inventory value of growing plants on hand at the beginning and end of the taxable year.<sup>2</sup>

However, in 1976 the Internal Revenue Service reversed its long-standing positions and ruled that an accrual method taxpayer engaged in farming is required to inventory growing crops (unless the taxpayer uses the crop method of accounting). This ruling also provided that nurserymen using an accrual method of accounting must inventory growing trees and that florists using an accrual method of accounting must inventory growing plants. In each case an exception was provided for taxpayers who use the crop method of accounting.<sup>3</sup> The changes made by this ruling were to be applied only for taxable years beginning on or after June 28, 1976, the date the ruling was

<sup>1</sup> I.T. 1368, I-1 C.B. 72 (1922).

<sup>2</sup> O.D. 995, 5 C.B. 63 (1921).

<sup>3</sup> Rev. Rul. 76-242, 1976-1 C.B. 132. Under the crop method of accounting, if a farmer is engaged in producing crops and the process of gathering and disposing of them is not completed in the year in which the crops are planted, the costs of producing, gathering, and disposing of the crops are taken into account in the taxable year the income from the crop is realized. Treas. Reg. § 1.162-12(a).

published in the Internal Revenue Bulletin. However, the effective date of this ruling has been postponed so that it applies only to taxable years beginning on or after January 1, 1978.<sup>4</sup>

On July 18, 1978, the Service announced that farmers, nurserymen and florists who have been using an accrual method of accounting without inventorying growing crops and who relied on the Service's former position would be allowed to change their method of accounting to the cash receipts and disbursements method of accounting, which does not require the accumulation of costs in inventory.<sup>5</sup>

With certain exceptions, the Tax Reform Act of 1976 required corporations and partnerships (in which non-excepted corporations are partners) engaged in farming to use an accrual method of accounting and to capitalize preproductive period expenses (sec. 447). However, subchapter S corporations, family corporations (in which one family owns at least 50 percent of the stock), corporations with annual gross receipts of \$1 million or less, and nurseries are not required to use an accrual method of accounting or to capitalize preproductive period expenses. In general, the requirement that preproductive period expenses be capitalized would have the effect of requiring taxpayers to inventory (or capitalize) the costs of growing crops.

The 1976 Act provisions generally are effective for taxable years beginning after December 31, 1976.

### *Reasons for change*

In 1976, Congress examined the area of tax accounting methods for persons engaged in agriculture. The 1976 Act required certain types of taxpayers engaged in farming to use an accrual method of accounting and to capitalize preproductive period expenses.<sup>6</sup> However, Congress expressed no intention that other taxpayers engaged in farming (or nurserymen or florists) should be required to change their methods of accounting by capitalizing preproductive period expenses.

It has come to the attention of the Congress that the Internal Revenue Service's change of position, as announced in Rev. Rul. 76-242, may have substantial adverse impact upon many farmers, florists, and nurserymen who have been using an accrual method of accounting without inventories of growing crops. At the time they made the election of accounting methods, these taxpayers had relied on the Service's long-standing position as to inventorying of growing crops. Also, at the time they elected their accounting methods, these taxpayers were generally eligible to elect the cash method of accounting for the income and deductions from their trades or businesses involving growing crops. The Congress believes that it is appropriate to allow these taxpayers to continue to use their accrual methods of accounting without inventorying growing crops until the Congress has an opportunity to examine this matter in more detail. Also, the Congress believes that taxpayers who are potentially affected by the ruling, but not required to use accrual accounting (under sec. 447), should be allowed to make an automatic change to the cash method of accounting for a limited period of time.

<sup>4</sup> Rev. Rul. 77-64, 1977-1 C.B. 136.

<sup>5</sup> Rev. Proc. 78-22, 1978-34 I.R.B. 26, also published as IRS Information Release 2017.

<sup>6</sup> Congress also made certain changes as to the timing of certain deductions for farming syndicates (sec 464).



### ***Explanation of provision***

This provision permits a farmer, nurseryman, or florist who is on an accrual method of accounting and is not required by section 447 of the Code to capitalize preproductive period expenses to be exempt from the requirement of Rev. Rul. 76-242 that growing crops be inventoried. This is intended to allow taxpayers who have been using an accrual method of accounting without inventorying crops under the prior Service position to continue to do so. Since the Congress understands that this revenue ruling does not affect the method of accounting of taxpayers who are growing trees for lumber, pulp or other nonlife purposes, such taxpayers are not covered by this provision.

This provision also allows those farmers, nurserymen, or florists who are eligible to use an accrual method of accounting without inventorying growing crops to elect, without the prior approval of the Internal Revenue Service, to change to the cash receipts and disbursements method of accounting with respect to any trade or business in which the principal activity is growing crops. However, this election may be initiated only with respect to a taxable year of the taxpayer beginning after December 31, 1977, and before January 1, 1981.

If a taxpayer elects to change to the cash method of accounting under this provision (or if he elects to modify his treatment of growing crops because of the operation of this provision), his change in method of accounting shall not require the consent of the Internal Revenue Service and shall be treated, for purposes of section 481 of the Code (relating to the adjustments to be made in cases involving a change in method of accounting), as a change in method of accounting initiated by the taxpayer.<sup>7</sup>

### ***Effective date***

This provision generally applies to taxable years beginning after December 31, 1977. However, the rules permitting a taxpayer to change to the cash method of accounting apply only with respect to taxable years beginning after December 31, 1977, and before January 1, 1981.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million per year.

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<sup>7</sup> The taxpayer may elect to change his method of accounting for growing crops while still being under the accrual method pursuant to this section if he had changed to, or adopted, an accrual method of accounting in which growing crops were inventoried pursuant to the Internal Revenue Service's published position in Rev. Rul. 76-242. If he has made such an election or change of method, it is intended that he should be able to change to an accrual method of accounting not involving the inventorying of growing crops under the authority of this section.

### **3. Treatment of Certain Farms for Purposes of Rules Requiring Accrual Accounting (sec. 353 of the Act and sec. 447 of the Code)**

#### ***Prior law***

With certain exceptions, the Tax Reform Act of 1976 required corporations (and partnerships in which non-excepted corporations are partners) engaged in farming to use an accrual method of accounting and to capitalize preproductive period expenses (sec. 447). However, subchapter S corporations, family corporations (in which one family owns at least 50 percent of the stock), corporations with annual gross receipts of \$1 million or less, and nurseries are not required to use the accrual method of accounting or to capitalize preproductive period expenses.

#### ***Reasons for change***

The 1976 Act excepted nurseries from the required accrual accounting and capitalization of preproductive period expense rules. The basic reason for this exception was that it takes several years from the time of planting for the trees raised by nurseries to reach a marketable condition. It is not clear whether this exception in prior law covers sod farms which, like nurseries, raise plants for landscaping and similar purposes. Since it takes up to 3 years to raise sod (from planting to harvesting), the Congress believes that sod farms should be exempted from the accrual accounting and capitalization of preproductive period expenses rules applicable to certain corporations and partnerships engaged in farming.

#### ***Explanation of provision***

The Act exempts sod farms from the requirements that certain farming corporations and partnerships use accrual accounting and capitalize preproductive period expenses. As is the case with the trade or business of operating a nursery, the trade or business of operating a sod farm is not a type of farming to which section 447 applies. However, this amendment to section 447 is not intended to affect the definition of "farming" under other provisions of the Code.

#### ***Effective date***

The provision applies to taxable years beginning after December 31, 1976.

#### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million per year.

## G. OTHER BUSINESS PROVISIONS

### 1. Expenses Relating to Entertainment Facilities (sec. 361 of the Act and sec. 274 of the Code)

#### *Prior law*

##### *In general*

Under present law, deductions are allowable for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business or for the production of income (secs. 162 and 212). Whether an expense is ordinary and necessary depends largely upon the particular facts and circumstances involved in each case. Ordinary and necessary business expenses which are deductible may include the cost of club dues or fees, and certain other expenditures relating to facilities. However, these expenses are deductible only if they both satisfy certain substantiation requirements (sec. 274(d)), and meet the other prerequisites for deductibility.

Generally, no deduction is allowed for entertainment expenses unless the taxpayer substantiates by adequate records, or by sufficiently corroborative evidence, (1) the amount of the expense, (2) the time and place of its occurrence, (3) its business purpose, and (4) the business relationship to the taxpayer of the person or persons entertained (sec. 274(d)). In addition, ordinary and necessary expenses are deductible only if the expenses are allocable to the taxpayer's business, and are reasonable in amount, i.e., not lavish or extravagant.

##### *Entertainment facilities*

Expenses with respect to entertainment "facilities" were deductible under prior law if (1) they were ordinary and necessary, (2) the facility was used primarily for the furtherance of the taxpayer's business (i.e., more than 50 percent of the time that it was used), and (3) the expense in question was "directly related" to the active conduct of the taxpayer's business.

For this purpose, an entertainment facility was any item of personal or real property owned, rented, or used by a taxpayer during the taxable year for, or in connection with, any activity which was of a type generally considered to constitute entertainment, amusement, or recreation. For example, entertainment facilities included yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, automobiles, airplanes, apartments, hotel suites, and vacation homes. However, a facility was not considered to be an "entertainment facility" if it was used only incidentally during a taxable year in connection with entertainment, and that use was insubstantial in relation to its business use. In the case of individuals and subchapter S corporations, apartments, hotel suites, vacation homes, and boats also may be subject to "vacation home" special disallowance rules under present law if there is a certain amount of personal use of the facility, i.e., the personal use exceeds the greater of 14 days or 10 percent of rental days (sec. 280A).

If an item of property was considered to be an entertainment facility, the expenditures subject to the special entertainment facility rules included depreciation, rent, utility charges, maintenance and repair expenses, insurance premiums, salaries for caretakers and watchmen, and losses realized on the sale or other disposition of the property. These expenditures also included dues and fees paid to any social, athletic, or sporting club or organization.<sup>1</sup> However, expenditures were not treated as being made with respect to a facility if they were out-of-pocket expenses, e.g., nonoperating costs such as expenditures for food and beverages. In addition, expenses attributable to a non-entertainment use of a facility were not treated as being expenses with respect to an "entertainment" facility, e.g., the use of an automobile or airplane for business travel purposes. Finally, expenses which were deductible without regard to their connection with a taxpayer's trade or business were not considered to be expenditures with respect to an entertainment facility, e.g., taxes, interest, and casualty losses.

In determining whether an entertainment facility was used primarily for business purposes, all the ordinary and necessary business use of the facility could be taken into account even though the use was not "directly related to" or "associated with" the active conduct of the taxpayer's profit-seeking activities (Rev. Rul. 63-144, 1963-2 CB-129, 137). However, only the portion of the expenses which were "directly related" to the active conduct of the taxpayer's trade or business were deductible. Thus, the use of the facility in providing entertainment "associated with" the active conduct of a trade or business was taken into account in determining if the facility was used primarily for business purposes, but only those expenses attributable to a use which was "directly related" to the active conduct of a trade or business were deductible. For example, if 60 percent of the use of a yacht was for business entertaining but only 45 percent of the use satisfied the "directly related" test, only 45 percent of the facility expenditures would have been deductible.

### ***Reasons for change***

Prior law's treatment of expenses relating to entertainment facilities encouraged some taxpayers to attempt to deduct, as business expenses, items that essentially represented nondeductible personal expenses. In some instances, the expenses were incurred largely as a method of providing additional compensation for highly paid employees and executives. The complexity of the provisions of prior law made its effective administration and uniform application extremely difficult and provided significant opportunities for abuse.

<sup>1</sup> While dues or fees paid to any social, athletic, or sporting club or organization were considered to be expenses incurred with respect to an entertainment facility, clubs operated solely to provide lunches under circumstances generally considered to be conducive to business discussions are exempted both under prior and present law. Cf. Treas. Regs. § 1.274-2(e)(3)(ii). In addition, dues paid to professional associations and civic organizations generally are exempt. Rev. Rul. 63-144, 1963-2 C.B. 129, 138-139. An initiation or similar fee which is payable only upon joining a club, and the useful life of which extends over more than one year, is a nondeductible capital expenditure. *Kenneth D. Smith*, 24 TCM 899 (1965).

### ***Explanation of provision***

The Act provides that no deduction is allowed for any expenses paid or incurred with respect to a facility which is used in conjunction with an activity which is of a type generally considered to constitute entertainment, amusement, or recreation.<sup>2</sup>

Generally, the term "facility" includes any item of real or personal property which is owned, rented, or used by a taxpayer in conjunction or connection with an entertainment activity. Thus, expenses incurred with regard to entertainment facilities which are disallowed, include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys. Facilities also may include airplanes, automobiles, hotel suites, apartments, and houses (such as beach cottages and ski lodges) located in recreational areas. However, the deduction is not affected unless the property is used in connection with entertainment. Expenses of an automobile or an airplane used on business trips will continue to be allowed.

As under prior law, club dues may be deductible<sup>3</sup> if a taxpayer can establish that the club is used primarily for the furtherance of his or her business, and that the expense in question is directly related to the active conduct of that business. In addition, the Act does not preclude a deduction for business meals or entertainment simply because the expense was incurred in a club with respect to which the taxpayer is not allowed a deduction for dues or fees, if the quiet business meal or associated with business test is satisfied for entertainment activities.

Similarly, the Act does not disallow an otherwise allowable deduction for meal and lodging expenses incurred while away from home overnight. For example, the Act generally does not apply to travel expenses incurred by an individual away from home at a bona fide business, trade, or professional organization meeting or convention. These expenses, however, continue to be subject to the generally applicable rules relating to the deductibility of business travel, convention, and entertainment activity expenses. For example, if a salesman took a customer hunting for a day at a commercial shooting preserve, the expenses of the hunt, such as hunting rights, dogs, a guide, etc.) would be deductible provided that the current law requirements of substantiation, adequate records, ordinary and necessary, directly related, etc. are met. However, if the hunters stayed overnight at a hunting lodge on the shooting preserve, the cost attributable to the lodging would be nondeductible but expenses for any meals would be deductible if they satisfied the requirements of current law. The shooting preserve should provide the taxpayer with an allocation of charges attributable to the overnight lodging for the taxpayer and guests.

<sup>2</sup> Such a facility would be considered to be an asset which is used for personal, living, or family purposes, and not as an asset used in the taxpayer's trade or business, or in a profit-seeking endeavor. As such, the investment tax credit would not be available upon the acquisition of such a facility.

<sup>3</sup> The language of the Act limits this exception to "country clubs". However, it is understood that the exception was intended to apply to all clubs with respect to which the taxpayer satisfies the business usage test. It is anticipated that the statutory language will be considered in connection with technical corrections to the 1978 Act.

The provisions of the Act also are inapplicable to expenditures for tickets to sporting and theatrical events, regardless of whether the tickets are purchased individually, in a series or by the season, or by an equivalent fee which entitles the taxpayer to use a seat. Ticket costs generally remain subject to the provisions of present law relating to entertainment activities, or to those which govern the deductibility of business gifts.

In addition, the Act continues a number of the present statutory exceptions to the facility expense rules. Thus, for example, otherwise allowable deductions for expenditures relating to the following items are not covered by the Act: (1) facilities located on the taxpayer's business premises and used in connection with furnishing food and beverages to employees, (2) certain employee recreational facilities, (3) facility expenses treated as employee compensation, (4) facilities made available to the general public, (5) facilities used in connection with a taxpayer's trade or business of selling entertainment for adequate and full consideration in bona fide transactions, and (6) facilities actively used in the taxpayer's business of selling such facilities. The Act, however, also continues any applicable present law limitations on these exceptions, including those pertaining to substantiation and allocation of expenses.

In addition to the above enumerated expenses, the disallowance rule does not apply to the extent allocable to that portion of the facility which otherwise qualifies as one which is not an entertainment facility, or to the extent that a facility, with respect to which expenses ordinarily would be denied as deductions, qualifies under one of the above exceptions. Similarly, expenses incurred with respect to certain transportation facilities, for example automobiles and airplanes, are allowable to the extent allocable to travel undertaken primarily for the furtherance of a trade or business even if the taxpayer engages in some entertainment activities during the business trip.

Although the Act disallows deductions which are predicated upon a profit-seeking intent, it does not apply to any deduction allowable without regard to the taxpayer's trade or business or income producing activity, e.g., interest (sec. 163), taxes (sec. 164), or casualty losses (sec. 165).

The Act applies to items paid or incurred (including the allowance for depreciation) after December 31, 1978, in taxable years ending after that date. Therefore, in the case of fiscal year taxpayers, only so much of an otherwise allowable depreciation deduction as is allowable with respect to periods prior to January 1, 1979 will be allowed.

### ***Effective date***

This provision is effective for expenditures paid or incurred after December 31, 1978, in taxable years ending after December 31, 1978.

### ***Revenue effect***

This provision will increase budget receipts by \$13 million in fiscal year 1979, \$29 million in fiscal year 1980, and \$38 million in fiscal year 1983.

## **2. Deficiency Dividend Procedure for Regulated Investment Companies (sec. 362 of the Act and sec. 860 of the Code)**

### ***Prior law***

Under present law, a regulated investment company (commonly called a mutual fund) is generally treated as a conduit for income tax purposes. The taxable income of the company which is distributed to investors each year is taxed to them without being taxed at the company level. The company is subject to the corporate income tax on the income it retains. This treatment is accomplished by allowing a deduction to the company for distributions to its shareholders.

In order to qualify for conduit treatment, a company must satisfy a number of requirements. Generally, the company must be a domestic corporation which is registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust. In addition, a company must satisfy requirements relating to the portion of gross income which must consist of investor-type income, the portion of assets which must be represented by cash and securities, the portion of its income which must be distributed to the investors, and its stock ownership. With respect to distributions, the company must distribute at least 90 percent of its taxable income, determined with certain modifications and without regard to the deduction for dividends paid, within its taxable year or, with certain limitations, within the 12-month period after the taxable year (secs. 852(a) and 855).

Under present law, a real estate investment trust is taxed generally in the same manner as a regulated investment company. The Tax Reform Act of 1976 added a deficiency dividend procedure for real estate investment trusts. However, unlike the treatment of real estate investment trusts, no deficiency dividend procedure was provided for regulated investment companies, under prior law, so that, under certain conditions, dividends paid after the taxable year and the following 12-month period may be taken into account for purposes of the 90-percent distribution requirement. Thus, a subsequent audit change by the Internal Revenue Service which increases income may have caused the company to fail to meet the distribution requirement.

### ***Reasons for change***

The Congress believes that a deficiency dividend procedure should be available to regulated investment companies because the penalty for failure to meet the distribution requirement is too severe. For this reason, the Congress believes that if a regulated investment company is audited by the Internal Revenue Service and there is a resulting adjustment that would increase the amount of dividends that must be paid for the year under audit for the company to meet the 90-percent distribution requirement, the company should be allowed to pay out deficiency dividends to its shareholders and thereby avoid disqualification. This deficiency dividend procedure is only to be available where failure of the regulated investment company to meet the 90-percent

distribution requirement was not due to fraud with intent to evade tax or to willful failure to file an income tax return within the required time.

Moreover, the Congress believes that providing a deficiency dividend procedure for regulated investment companies is consistent with the treatment presently accorded to real estate investment trusts which are taxed in generally the same manner.

### ***Explanation of provision***

The Act provides a deficiency dividend procedure for regulated investment companies.<sup>1</sup> Under the procedure, the company could make qualifying distributions after the regular period for making distributions when an adjustment by the Internal Revenue Service occurs that either increases the amount which the corporation is required to distribute to meet the distribution requirement or decreases the amount of the dividends previously distributed for that year. This deficiency dividend procedure would be available only where the entire amount of the adjustment is not due to fraud with intent to evade tax or willful failure to file an income tax return.

Interest at the regular rate would be imposed on the amount of the deficiency dividend. In addition, a penalty equal to the interest charge would be imposed, but the penalty could not exceed 50 percent of the deficiency dividend. The imposition of a penalty and interest is designed to discourage a company from reducing its current distributions of income in reliance on the availability of the deficiency dividend procedure to retain its qualified status.

The procedure is similar to the deficiency dividend procedure provided for real estate investment trusts by the Tax Reform Act of 1976.

### ***Effective date***

The provision is effective with respect to determinations made after the date of enactment (November 6, 1978).

### ***Revenue effect***

This provision will reduce budget receipts by about \$200,000 in fiscal year 1979 and by less than \$500,000 annually thereafter.

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<sup>1</sup> This provision was added to the Revenue Act of 1978 by a Senate Finance Committee amendment. The provision was the subject matter of a separate bill, H.R. 6877, which was reported by the House Ways and Means Committee (H. Rept. 95-1537, September 6, 1978) and passed by the House on October 3, 1978.



### **3. Safe Harbor Rule for Real Estate Investment Trusts (sec. 363 of the Act and secs. 856 and 857 of the Code)**

#### ***Prior law***

Under present law, a real estate investment trust (commonly called a "REIT") is generally treated as a conduit for income tax purposes. The taxable income of the REIT which is distributed to its shareholders each year is taxed to them without being subject to a tax at the REIT level. The REIT is subject to the corporate income tax on the income it retains. This treatment is accomplished by allowing a deduction to the REIT for its distributions to its shareholders. The Code contains a number of provisions which permit the conduit treatment only where the REIT does not engage in an active trade or business.

Under one of these rules that was in effect prior to the Tax Reform Act of 1976, a REIT could not hold any property primarily for sale in the ordinary course of its trade or business. If a REIT did hold any property primarily for sale, it did not qualify for tax conduit treatment that year.

This "primarily held for sale" rule produced a particularly harsh result where the REIT acquired property through a foreclosure of a lease or mortgage. As a result, Congress provided in 1974 a special rule for foreclosure property which permitted the REIT to hold property acquired by foreclosure for a period of 2 years (with permissible extensions by the IRS for another 2 years) if the REIT paid the normal corporate income tax on income from the foreclosure property. This special rule for foreclosure property permitted a REIT a reasonable period to orderly liquidate the foreclosure property.

While the foreclosure property rules provided substantial relief, disqualification was a harsh penalty to impose where a REIT had only a relatively small amount of property primarily held for sale which was not subject to the foreclosure property rule. As a result, Congress, in the Tax Reform Act of 1976, removed the restriction for property held for sale and, in its place, imposed a 100-percent tax on gain from property held primarily for sale. The Congressional intent in imposing the 100-percent penalty tax was to permit a REIT to hold property primarily for sale, but to not let the REIT derive any profit from holding property primarily for sale.

#### ***Reasons for change***

Despite the fact that the 100-percent penalty tax is more lenient than the complete disqualification rule under the pre-1976 Act law, the penalty tax may restrict the ability of a REIT to change a substantial portion of its real estate investments, particularly because it is often very unclear whether property is being held by a REIT primarily for sale. The Congress believes that REITs should have a safe harbor within which they can modify the portfolio of their assets without the possibility that a tax would be imposed equal to the entire amount of

the appreciation in those assets. However, the Congress believes that this safe harbor rule should be restricted to only types of assets which are owned and operated by the REIT for a substantial period of time and to which the REIT has not made substantial improvements during the last four years that it owned the property. In addition, the rule is limited to cases where the REIT had no more than five sales during the taxable year. The Congress believes that these restrictions will prevent REITs from using the safe harbor rule to permit them to engage in an active trade or business such as the development and subdivision of land.

### ***Explanation of provision***

The Act provides that the 100-percent penalty tax on property held primarily for sale by a REIT will not apply to the sale of property where the following conditions are met: (1) the property has been held by the REIT for at least four years, (2) the total expenditures made by the REIT during the four-year period prior to sale do not exceed 20 percent of the net selling price of the property, (3) the REIT does not sell more than five properties during the taxable year, and (4), if the property is land or improvements not acquired through foreclosure, the property is held by the REIT for rent for a period of at least four years.

For purposes of the four-year holding requirement, the length of time that the REIT is deemed to hold the property that was acquired by the REIT through foreclosure (or deed in lieu of foreclosure), or termination of a lease, includes the period that the REIT held the loan which secured the property or that the REIT was the lessor of the property.

For purposes of the 20-percent expenditure requirement, any expenditures on property that has been acquired by the REIT through foreclosure (or deed in lieu of foreclosure) or termination of a lease, which are made by, or for the account of, a mortgagor or lessee after the default became imminent, are considered to be expenditures made by the REIT. Nonetheless, expenditures (including expenditures regarded as made by the REIT under the prior rule) do not count towards the 20-percent limitation if the expenditures relate to the foreclosure property and those expenditures did not cause the property to lose its status as foreclosure property. In addition, expenditures made solely to comply with standards or requirements of any government and expenditures made to restore property as a result of losses arising from fire, storm, or other casualty are not counted towards the 20-percent limitation. Lastly, where a REIT makes a loan under which the debtor is advanced additional monies at different times (such as is typically done in the case of a construction loan), the advance on the loan is not treated as an expenditure by the REIT unless default on the loan has become imminent.

With regard to the not more than five sales per year rule, the sale of more than one property to one buyer as part of one transaction is to be treated as one sale. For this purpose, the properties need not be contiguous or located near each other. However, all of the properties sold to the one buyer must be part of the same transaction. In addition, the Act provides that sales where the net selling price (total selling price less related selling expenses) is less than \$10,000 are to

be disregarded for purposes of counting the permissible 5 sales per year. If a REIT sells more than five properties under the rule, the safe harbor rule does not apply to the REIT for that taxable year and none of the sales is protected by the safe harbor rule. Any sale or other disposition of property is counted towards this rule (unless excluded under the \$10,000 exception) regardless of whether the transaction resulted in a gain or a loss to the REIT.

For purposes of the rental test, any rental of the property at an insignificant rate of rent or for a use which indicates that the purpose of the rental arrangement was not for the production of rental income is to be disregarded. For example, where a REIT holds developed land in order to derive gain from the sale of the property, the property cannot qualify under the safe harbor rule simply by having the REIT rent the property at a rent substantially below the rental rate of comparable property. Similarly, where a REIT holds undeveloped land in order to derive gain from the sale of the property, the property cannot qualify under the safe harbor rule by having the REIT rent the property for a use such as for horseback riding trails or for hunting even though the rent received by the REIT is a fair rent from the property for that use.

The Act also provides that the fact that a sale does not come within the requirements of the safe harbor rule (including transactions occurring before the effective date of the provision) is not to be taken into account in determining whether the sale constitutes a prohibited transaction. Whether or not such a sale constitutes a prohibited transaction is to be determined under the facts and circumstances of each case as if the safe harbor rule had not been enacted. In addition, the mere fact that a sale comes within the safe harbor rule is not to be taken into account in determining whether any gain or loss on the sale is entitled to capital gain treatment.

In addition, the Act would increase the additional period that the IRS may grant to a REIT to hold foreclosure property from two years to four years (for a total of six years that foreclosure property may be held).

### ***Effective date***

The provision for a safe harbor rule is effective for taxable years ending after the date of enactment (November 6, 1978). The provision increasing permissible extension periods is effective for extensions granted after the date of enactment (November 6, 1978) with respect to extension periods beginning after December 31, 1977.

### ***Revenue effect***

This provision will not have any revenue effect.

#### **4. Contributions in Aid of Construction to Regulated Electric or Gas Public Utilities (sec. 364 of the Act and sec. 118 of the Code)**

##### ***Prior law***

###### ***In general***

Generally, contributions to the capital of a corporation, whether or not contributed by a shareholder, are not includible in the gross income of the corporation (sec. 118). Nonshareholder contributions of property to the capital of a corporation have a zero basis to the corporation. If money is contributed by a nonshareholder, the basis of any property acquired with the money during the 12-month period beginning on the date the contribution is received, or of certain other property, is reduced by the amount of the contribution (sec. 362(c)).

###### ***Tax treatment prior to the Tax Reform Act of 1976***

Early in the development of the Federal income tax laws, there were a number of court decisions which held that customer contributions to public utilities to pay for the costs of extension service lines were to be treated as contributions to capital, and not as income, of the public utility.

In 1958, the Internal Revenue Service announced that it would apply that early case law with respect to contributions in aid of construction, but only with respect to regulated utilities (Rev. Rul. 58-535, 1958-2 C.B. 25). In 1975, the Internal Revenue Service issued Rev. Rul. 75-557 (1975-2 C.B. 33) which revoked the 1958 ruling, withdrew the acquiescences in the early line of cases, and held that amounts paid by the purchaser of a home in a new subdivision as a connection fee to obtain water service were includible in the utility's income. The ruling was made prospective for transactions entered into on or after February 1, 1976.

###### ***Tax treatment after the Tax Reform Act of 1976***

Generally, the Tax Reform Act of 1976 provided that contributions in aid of construction to regulated public water and sewerage utilities (but not other utilities) are to be treated as nontaxable contributions to capital. However, nontaxable treatment was not provided for customer connection fees. Customer connection fees include payments made by a customer to the utility for the cost of installing the connection between the customer's line and the utility's main water or sewer lines (including the cost of meters and piping) and any amounts paid as service charges for stopping or starting service. In addition, a water or sewerage utility which receives a nontaxable contribution in aid of construction is not entitled to any depreciation deductions or investment tax credits with respect to property acquired with the nontaxable contribution.

A contribution to the capital of a regulated public water or sewerage utility qualifies for nontaxable treatment if it is a contribution in aid of construction under regulations prescribed by the Secretary of

the Treasury<sup>1</sup> and if the property contributed, or property acquired with the contribution, is not included in the rate base for rate-making purposes. Where the contribution is in property which is other than water or sewerage disposal facilities, the contribution must be used for a qualified expenditure.<sup>2</sup> Amounts not used for qualified expenditures must be included in income for the taxable year in which received.<sup>3</sup>

The 1976 Act did not affect the treatment of contributions to utilities other than water and sewerage utilities.

### ***Reasons for change***

The Congress believes that contributions in aid of construction to regulated public gas and electric utilities should be treated as nontaxable receipts in the same manner as contributions made to water and sewerage utilities. Since the imposition of an income tax on contributions in aid of construction reduces a utility's working capital until recovered through higher consumer charges, nontaxable treatment of the contributions will assist a utility in meeting demands for new and increased services. Further, nontaxable treatment would eliminate mismatching of income and expense with respect to contributions in aid of construction which might arise if contributions are fully taxable in the year of receipt and deductions attributable to the expenditure of the contributions are allowable in later years.<sup>3</sup>

### ***Explanation of provision***

The Act extends the present law provisions, which are applicable to contributions in aid of construction to water and sewerage utilities, to contributions made to regulated public gas and electric utilities.<sup>4</sup> Thus, contributions in aid of construction received by these utilities will be treated as nontaxable contributions to capital by nonshareholders, and not as a taxable income, to the utility. However, customer connection fees will be treated as taxable income.<sup>5</sup> Also, no depreciation and in-

<sup>1</sup> Proposed regulations under sec. 118 were published May 30, 1978 (43 Fed. Reg. 22997).

<sup>2</sup> A qualified expenditure is an amount which is expended for the acquisition or construction of tangible property described in sec. 1231(b), where the acquisition or construction of the facility was the purpose motivating the contribution. For this purpose, a capital asset includes all expenditures which must be capitalized for such facilities under the normal rules of tax accounting (sec. 263). The assets must be used predominantly (i.e., 80 percent or more) in a trade or business of furnishing water or sewerage services to the utility's customers. Expenditures must be made by the end of the second taxable year after the year in which the money was received.

<sup>3</sup> Accurate records must be kept of the amounts contributed on the basis of the project for which the contribution was made and by year of contribution.

<sup>4</sup> This provision was added to the Revenue Act of 1978 by a Senate Finance Committee amendment. The provision was the subject matter of a separate bill, H.R. 11741, which was reported by the House Ways and Means Committee (H. Rep. No. 95-1577, September 18, 1978) and was passed by the House on October 3, 1978.

<sup>5</sup> Under present law, customer connection fees include amounts paid to connect the customer's "property" to a main water or sewer line. The Act revises the statutory language to refer to amounts paid to connect the customer's "line" to a main line. This language change was made to reflect the inclusion of public electric utilities. Thus, it is clear under the Act that, where the main line is located on or under the property of the customer, a customer connection fee does not include amounts for the installation of the main line. However, a customer connection fee includes amounts for the installation of the connecting line between the main line and the customer's line located in his home (or other place where the customer's ownership of the line begins) regardless of whether that connecting line was located on or under his property or the property of another.

vestment tax credits will be allowable with respect to nontaxable property contributions or property acquired with nontaxable contributions.

A gas transmission utility which provides gas services which are resold to the general public is considered to be a regulated public gas utility for purposes of the provision. Also, contributions in aid of construction of steam facilities are covered by the provision.

In providing special rules for gas and electric utilities, the Congress intends that no inference should be drawn as to the proper treatment of contributions in aid of construction to other utilities.

### ***Effective date***

The Act applies to contributions made after January 31, 1976.

### ***Revenue effect***

If all the contributions in aid of construction to gas and electric utilities were treated as income, the annual increase in tax liabilities is estimated to be in the range of \$130-\$200 million. This estimate takes into account the increases in the amounts the utilities would charge to their customers if all the contributions were treated as income to the utilities. It is uncertain when these tax liabilities would first be reflected in higher budgets receipts, however. If the electric and gas utilities rely on past treatment and file tax returns as if Revenue Ruling 75-557 were an incorrect interpretation of the law, higher assessments of taxes against the electric and gas utilities probably would not occur until their 1976 tax returns are audited, probably some time during calendar year 1979. Some of these assessments undoubtedly would be contested in court, but some might not. Thus, the first major impact on the budget receipts would very likely be in fiscal year 1980, but the timing of the higher tax payments and the amounts cannot be estimated by fiscal year with any degree of accuracy.

On the other hand, if Revenue Ruling 75-557 were held to be incorrect by court decisions, then the proposal to broaden section 2120 of Public Law 94-455 would have no revenue effect because it could be viewed as codifying the pre-1976 tax treatment of contributions in aid of construction (other than customer connection fees) of regulated utilities.

## 5. Liabilities of Controlled Corporations (sec. 365 of the Act and secs. 357(c) and 358(d) of the Code)

### *Prior law*

No gain or loss generally is recognized for Federal income tax purposes on the transfer of property and associated liabilities to a corporation (usually upon its incorporation) solely in exchange for its stock or securities, where the transferors of such property control the corporation (i.e., in general, own 80 percent or more of the stock) immediately after the exchange (sec. 351). However, gain is recognized to the extent that the sum of the amount of liabilities assumed by the corporation, plus the amount of liabilities to which the property is subject, exceeds the adjusted basis of the property transferred to the corporation (sec. 357(c)).<sup>1</sup>

In recent years, considerable uncertainty has arisen over the treatment of certain liabilities (such as accounts payable) if assumed by the corporation when property is transferred, upon incorporation or in other generally tax-free asset-for-stock exchanges under section 351, by a taxpayer using the cash-basis accounting method.

Until recently, the United States Tax Court has given the term "liabilities" as used in section 357(c) an all-inclusive meaning.<sup>2</sup> Under this interpretation, a cash-basis taxpayer may be subject to recognition of gain upon incorporation of his or her trade or business. Thus, if the sum of the liabilities (including accounts payable) of a cash-basis taxpayer exceeds the basis of the taxpayer's assets, gain is recognized under section 357(c) even though there were neither tax benefits realized by the transferor on liabilities assumed by the corporation nor withdrawal of borrowed cash through loans made against assets transferred to the corporation prior to the transfer.

Three approaches have been developed by courts to alleviate this problem.

One alternative is that adopted by the Second Circuit in *Bongiovanni v. Comm'r*, 470 F. 2d 921 (2d Cir. 1972), which held that the term "liability" for purposes of section 357(c) does not include accounts payable. The Second Circuit stated that

"Section 357(c) was meant to apply to what might be called 'tax liabilities', i.e., liens in excess of tax costs, particularly mortgages encumbering property transferred in a Section 351 transaction. \* \* \* The payables of a cash basis taxpayer are 'liabilities' for accounting purposes but should not be considered 'liabilities' for tax purposes under Section 357(c) until they are paid." 470 F. 2d at 924 (emphasis in original).

<sup>1</sup> Section 357(c) also applies to reorganizations within the meaning of section 368(a) (1) (D).

<sup>2</sup> *Raich v. Comm'r*, 46 T.C. 604 (1966); *Thatcher v. Comm'r*, 61 T.C. 28 (1973), rev'd in part and aff'd in part, 533 F. 2d 1114 (9th Cir. 1976); *Bongiovanni v. Comm'r*, 30 CCH Tax Ct. Mem. 1124 (1971), rev'd 470 F. 2d 921 (2d Cir. 1972).

The second judicial approach developed is that while no deductions are ordinarily available in section 351 exchanges, section 357(c) turns the transaction into an ordinary exchange for the purpose of recognizing gain. Since there is some authority for the proposition that in an ordinary exchange the assumption of liabilities by the purchaser will give the taxpayer an immediate deduction,<sup>3</sup> it was concluded that the transferor should receive a deduction for trade accounts payable discharged by the transferee in the same year as the transfer, to the extent of the accounts receivable or the gain recognized under section 357(c), whichever is less. This approach was suggested in a dissenting opinion by Judge Hall in the *Thatcher* case in the Tax Court, and was, in general, adopted by the Ninth Circuit in reversing the Tax Court's decision on this issue.<sup>4</sup> Under this approach, the deduction is allowed to the transferor only when the transferee corporation pays the assumed liability. Accordingly, it appears that under the Ninth Circuit's approach, the transferor could obtain a deduction on discharge of the transferred accounts payable in a year subsequent to the year of transfer.

Third, the Tax Court in the *Focht* case<sup>5</sup> reversed its longstanding position on the treatment of accounts payable under section 357(c). Under the Tax Court's revised approach, the term "liability" under section 357(c) would be limited to those obligations which, if transferred, cause gain recognition under *Crane v. Comm'r*, 331 U.S. 1 (1947), and an obligation would not be treated as a liability to the extent that its payment would have been deductible if made by the transferor. The Tax Court also held in *Focht* that under section 358, deductible liabilities are excluded in determining the transferor's basis in stock received as part of the exchange.

### ***Reasons for change***

The ambiguity of the prior law resulted in differing judicial interpretations of the term "liabilities," and in some cases resulted in unforeseen and unintended tax difficulties for certain cash basis taxpayers who incorporated a going business. Although the more recent judicial trend has been to exclude certain deductible liabilities from the scope of sections 357(c) and 358(d), no uniform rationale for that result has been developed by the courts. The Congress therefore believes that it is appropriate to resolve the ambiguity as to whether, for purposes of sections 357(c) and 358(d), the term liabilities includes deductible liabilities of a cash basis taxpayer.

### ***Explanation of provision***

Under the Act, in determining (for purposes of sections 357(c) and 358(d)) the amount of liabilities assumed, or to which the property transferred is subject, in a transfer qualifying under section 351, the amount of certain liabilities are excluded for a cash basis transferor. Liabilities excluded under this provision are those which constitute

<sup>3</sup> *James M. Pierce Corp. v. Comm'r*, 326 F. 2d 67 (8th Cir. 1964).

<sup>4</sup> *Thatcher v. Comm'r*, 61 T.C. 28, 43 (1973) (Hall, J., dissenting), rev'd on this issue, 533 F. 2d 114 (9th Cir. 1976).

<sup>5</sup> *Focht v. Comm'r*, 68 T.C. 223 (1977).



an amount payable described in section 736(a)<sup>6</sup> and certain liabilities which constitute an account payable of the transferred business. However, an account payable may be excluded under this provision only to the extent payment thereof by the transferor would have given rise to a deduction. In addition, an account payable would not be excluded under this provision to the extent that the incurrence of the obligation resulted in the creation of, or increase in, the basis of any property.<sup>7</sup>

For purposes of this provision, a determination of whether a transferor is a cash basis taxpayer is to be made for each item. For example, a taxpayer on a hybrid method of accounting which utilizes inventories in computing income from purchases and sales, and utilizes the cash method in computing all other items of income and expense shall be considered a cash basis taxpayer for purposes of this provision. Accordingly, the transferor's accounts payable for items computed on the cash method of accounting may be excluded under this provision to the extent payment thereof (by the transferor) would have given rise to a deduction.

Additionally, for purposes of this provision, accounts payable mean, in general, those trade accounts payable and other liabilities (e.g., interest and taxes) which relate to the transferred trade or business and which constitute cash method items.

The provision further provides that in determining the transferor's basis in stock received in the exchange, liabilities excluded from the provisions of section 357(c) would not be treated as liabilities assumed, or to which property is subject, for purposes of section 358(d). Thus, the amount of such excluded liabilities would not reduce the transferor's basis in stock received in the exchange.

Finally, the provision is not intended to affect the corporate-transferees' tax treatment of the excluded liabilities. It also is not intended

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<sup>6</sup> Section 736(a) applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's active interest in the partnership. If such payments meet the requirements of section 736, they are considered either as a distributive share of partnership income to the recipient or as guaranteed payments. If the payments are considered a distributive share of partnership income, then the distributive shares of the other partners are reduced. If payments are guaranteed payments, then they are deductible under section 162 by the partnership.

In either instance, for cash basis taxpayers the obligation to make such payments is similar to the partnership's obligation with respect to its (deductible) accounts payable since both would constitute ordinary deductions or would reduce gross income to the non-retiring partners when the obligations are paid. Accordingly, under the Act, section 736(a) payments would be excluded in determining the amounts of liabilities assumed or to which the property transferred is subject for purposes of sections 357(c) and 358(d).

<sup>7</sup> The exception for obligations which give rise to basis would apply, for example, where a cash-basis taxpayer purchases small tools on credit and, prior to paying for the tools, transfers them along with the related obligation to a new corporation in a section 351 transaction. While the transferor would have been entitled to a deduction if he had paid off the obligation, pending payment he would have a basis in the tools equal to the amount of the unpaid obligation. Under the provision, that obligation would constitute a "liability" for purposes of section 357(c); but the amount of this liability would be offset by the basis in the transferred tools.

to affect the definition of the term liabilities for any other provision of the Code, including sections 357(a) and 357(b).

***Effective date***

The provision applies to transfers of property to corporations made on or after the date of enactment (November 6, 1978).

***Revenue effect***

This provision will reduce budget receipts by less than \$5 million annually.

## **6. Medical Expense Reimbursement Plans (sec. 366 of the Act and sec. 105 of the Code)**

### ***Prior law***

Under prior law, gross income did not include amounts received under a self-insured accident or health plan as reimbursement for employee medical expenses, unless the expenses were deducted in a prior taxable year.

### ***Reasons for change***

In some cases, uninsured medical reimbursement plans have been established by businesses under which the principal beneficiaries are the officers of the company, its major shareholders, and its highest paid workers. These plans could tailor their benefits to fit the particular needs of these selected employees, for example, by excluding all rank-and-file workers.

### ***Explanation of provision***

Under the Act, self-insured medical reimbursement plans are made subject to rules regarding discrimination as to eligibility and benefits in favor of employees who are officers, shareholders, or highly paid. Reimbursements to an officer, etc., under a discriminatory plan are wholly or partly includible in the recipient's income.

The Act applies only to an employer's uninsured plan or arrangement for reimbursement of employee expenses incurred for medical care (as defined in sec. 213(e)) for the employee, the employee's spouse, or the employee's dependents. Under the Act, a plan is considered self-insured if reimbursement is not provided under a policy of accident insurance, health insurance, or accident and health insurance.

Under the Act, a plan satisfies the nondiscriminatory eligibility requirements if it meets either of two standards which are similar to the nondiscriminatory eligibility requirements applicable to qualified pension plans (sec. 410(b)). Under the first alternative eligibility standard, a plan must benefit at least 70 percent of all employees (or at least 80 percent of all eligible employees if at least 70 percent of the employees are eligible). Under the second alternative eligibility standard, a plan must benefit a classification of employees set up by the employer and found by the Secretary of the Treasury not to be discriminatory in favor of employees who are highly compensated individuals. In applying the alternative eligibility standards, the Act provides that there may be excluded from consideration any employee who (1) has not completed 3 years of service, (2) has not attained age 25, or (3) is a part-time or seasonal employee. Under the Act, an employee whose customary weekly employment is for less than 35 hours is considered part-time and an employee whose customary annual employment is for less than 9 months is considered seasonal.

In addition, employees in a collective bargaining unit can be excluded from consideration under rules similar to those provided for

qualified pension plans (sec. 410(b)(2)(A)) if there is evidence that accident and health benefits were the subject of good faith bargaining. Similarly, the Act provides for the exclusion of nonresident aliens as under the pension plan rules (sec. 410(b)(2)(C)).

In addition to the requirement of nondiscriminatory eligibility, the Act provides that benefits under a medical reimbursement plan must not discriminate in favor of participants who are highly compensated individuals. The Act specifies that a plan does not meet the requirement of nondiscriminatory benefits unless all benefits provided for participants who are highly compensated individuals are also provided for all other participants. In testing plan benefits for discrimination, all facts and circumstances are to be taken into account. (Consequently, if a plan (or a particular benefit provided by a plan) is terminated, the termination would cause plan benefits to be discriminatory if the limited duration of the plan (or benefit) has the effect of discrimination in favor of the highly compensated. This situation could arise, for example, where the duration of a particular benefit roughly coincides with the period during which a highly compensated individual utilizes that benefit.)

The requirements of the Act as to nondiscriminatory eligibility and benefits are not violated merely because benefits under an employer's plan are offset by benefits paid under a self-insured or insured plan of the employer or another employer, or by benefits paid under Medicare or other Federal or State law.

Under the Act, a highly compensated individual is (1) one of the five highest paid officers, (2) a shareholder (owning more than 10 percent of stock, directly or indirectly), or (3) one of the highest paid 25 percent of all employees (other than employees who may be excluded from consideration).

Medical reimbursement benefits provided for an employee who qualifies for the benefits on (or before) November 6, 1978, and who is not employed by the employer after that date are not considered to be provided under a medical reimbursement plan. Accordingly, the employee and the benefits are disregarded in testing any medical reimbursement plan of the employer for discriminatory eligibility or benefits and the tax treatment of the benefits paid to the employee is not affected by the medical reimbursement plan rules of the Act.

The Act provides that an excess reimbursement to a highly compensated individual during a plan year under a self-insured medical reimbursement plan is includible in the gross income of the individual for the taxable year in which (or with which) the plan year ends. Under the Act, a reimbursement is an excess reimbursement if it is a discriminatory benefit, that is, if it is made under a plan benefit which is provided for a participant who is a highly compensated individual, but not to all participants who are not highly compensated individuals.

Also, under the Act, a portion of the total amount reimbursed during a plan year to each participant who is a highly compensated individual is an excess reimbursement if the plan does not meet the nondiscriminatory eligibility requirements. The excess reimbursement portion is determined by multiplying the total amount reimbursed to the participant during the plan year by a fraction, the numerator of which is the total amount reimbursed during that year

to all participants who are highly compensated individuals and the denominator of which is the total amount reimbursed during that year to all participants. In computing the amount of an excess reimbursement because a plan does not meet the nondiscriminatory eligibility requirements, however, discriminatory benefits are not taken into account.

The Act authorizes the Secretary of the Treasury to prescribe necessary regulations. It is anticipated that these regulations will provide that reimbursement for diagnostic procedures (medical examinations, X-rays, etc.) need not be considered by an employer to be a part of a medical reimbursement plan. However, this exception is to apply only for diagnostic procedures performed at a facility which provides no services other than medical services and ancillary services and applies to travel expenses only to the extent such expenses are ordinary and necessary. Under the Act, if a self-insured medical reimbursement plan is included in a "cafeteria plan", the medical reimbursement plan rules determine the status of a benefit as a taxable or nontaxable fringe benefit and the cafeteria plan rules determine whether an employee is taxed as though he elected all available taxable benefits (including taxable benefits under a discriminatory medical reimbursement plan).

Although no advance rulings from the Internal Revenue Service are required, it is expected that, in a typical case, advance rulings will be available. It is also anticipated that a determination by the Service that a plan is discriminatory will not be applied retroactively where the plan has made reasonable efforts to comply with the discrimination rules.

### ***Effective date***

The provision applies for taxable years beginning after December 31, 1979.

### ***Revenue effect***

This provision will have no revenue effect in fiscal year 1979, and will increase budget receipts by less than \$5 million per year thereafter.

## **7. Extension of 5-Year Amortization for Low-Income Rental Housing (sec. 367 of the Act and sec. 167(k) of the Code)**

### ***Prior law***

Under the Code, special depreciation rules are provided for expenditures to rehabilitate low-income rental housing (sec. 167(k)). Low-income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income. Occupants of a dwelling unit are considered families and individuals of low or moderate income only if their income does not exceed certain limits, as determined by the Secretary of Treasury in a manner consistent with the limits established for the Leased Housing Program under section 8 of the United States Housing Act of 1937, as amended.

Under the special depreciation rules for low-income rental property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under a straight-line method over a period of 60 months, if the additions or improvements have a useful life of 5 years or more. Under present law, only the aggregate rehabilitation expenditures for any housing which do not exceed \$20,000 per dwelling unit qualify for the 60-month depreciation. In addition, for the 60-month depreciation to be available, the sum of the rehabilitation expenditures for 2 consecutive taxable years—including the taxable year—must exceed \$3,000 per dwelling unit.

### ***Reasons for change***

The special tax incentive for rehabilitation expenditures for low- and moderate-income rental housing under present law expires on December 31, 1978. In order to avoid discouraging this rehabilitation, the Congress believes that the special depreciation provision for low-income rental housing should be extended for an additional three years.

### ***Explanation of provision***

The Act provides a three-year extension of the special 5-year depreciation rule for expenditures to rehabilitate low-income rental housing. Under the Act, rehabilitation expenditures that are made pursuant to a binding contract entered into before January 1, 1982, would qualify for the 5-year depreciation rule even though the expenditures are actually made after December 31, 1981.

### ***Effective date***

The three-year extension applies to expenditures paid or incurred with respect to low- and moderate-income rental housing after December 31, 1978, and before January 1, 1982 (including expenditures made pursuant to a binding contract entered into before January 1, 1982).

### ***Revenue effect***

This provision will reduce budget receipts by \$1 million in fiscal year 1979, \$4 million in 1980, and \$24 million in fiscal year 1983.

## **8. Postponement of Effective Date for Special Limitations on Net Operating Loss Carryovers (sec. 368 of the Act and sec. 382 of the Code)**

### ***Prior law***

Prior to enactment of the Tax Reform Act of 1976, generally, if new owners purchased 50 percent or more of the stock of a loss corporation during a 2-year period, the corporation's loss carryovers from prior years were allowed in full only if the corporation continued to conduct its prior trade or business or substantially the same kind of business. Generally, if the same business was not continued, however, loss carryovers were completely lost. This "purchase" rule applied where one or more of the 10 largest shareholders increased their stock ownership, within a 2-year period, by 50 percentage points or more in a transaction in which the purchasers took a cost basis in their stock (except where the stock was acquired from "related" persons).

In the case of a tax-free reorganization, loss carryovers were allowed on a declining scale. If the former owners of the loss company received 20 percent or more of the fair market value of the stock of the acquiring company, the loss carryovers were allowed in full. For each percentage point less than 20 which the former owners received, the loss carryover was reduced by 5 percent. It was immaterial whether the business of the loss company was continued after the reorganization.

The 1976 Act extensively revised the Code provisions dealing with the carryover of net operating losses in cases of acquisitions of loss corporations. The limitations on loss carryover attributes were to apply to acquisitions made by purchase or through corporate reorganizations. The new provisions changed the basic concepts underlying the rules by deleting continuity of business requirements for purchases and establishing a new continuity of ownership test applicable to both purchases and reorganizations.

These new provisions were to apply to plans of reorganization adopted on or after January 1, 1978, and to sales or exchanges in taxable years beginning after June 30, 1978.

### ***Reasons for change***

A number of technical problems regarding the 1976 Act revisions to the net operating loss carryover rules have been brought to the attention of Congress. These problems will require consideration of additional revision of the rules.

### ***Explanation of provision***

The Act delays the effective date of the 1976 change until January 1, 1980, with respect to plans of reorganization adopted on or after that date, or until June 30, 1980, with respect to sales or exchanges occurring in taxable years beginning after that date. It also permits taxpayers to elect to have the 1976 changes apply to any acquisition or reorganization occurring before the close of the taxpayer's first taxable

year beginning after June 30, 1978. This election applies only if the acquisition or reorganization occurs pursuant to a contract or option to acquire stock or assets entered into before September 27, 1978.

***Revenue effect***

The provision will reduce budget receipts by less than \$5 million annually during the postponement period.



**9. Use of Certain Expired Net Operating Loss Carryovers and Redemptions of United States Railway Association Certificates of Value in a Tax-Free Reorganization of a Transferor Railroad (sec. 369 of the Act and sec. 374 of the Code)**

***Prior law***

On April 1, 1976, a number of insolvent midwestern and northeastern railroads, along with many of their subsidiaries and affiliates, transferred their railroad properties to the Consolidated Rail Corporation (ConRail). These transfers were mandated and approved by the Congress<sup>1</sup> in order to provide financially self-sustaining rail services in areas served by these bankrupt railroads.

Under this legislation, ConRail, a taxable corporation, was to acquire, rehabilitate, and operate the railroad properties. The transferor railroads (and their subsidiaries and affiliates) will receive ConRail stock and "certificates of value" issued by the United States Railway Association, a nonprofit Government corporation formed to oversee the ConRail reorganization. A special court will eventually determine the value of these certificates in order to set the amount of compensation the transferor railroads will receive for their properties.

In 1976, the Congress also enacted legislation to deal with the tax consequences of this reorganization to ConRail, the transferor railroads, and the shareholders and creditors of the transferor railroads. Under this legislation,<sup>2</sup> the transfer of rail properties to ConRail is treated like reorganizations in general (and other bankrupt railroad reorganizations in particular) so that the transferor companies and their shareholders and security holders do not recognize gain or loss on the transfer and ConRail receives a carryover basis in the properties it acquired.

This legislation also included rules which allowed a transferor railroad's net operating losses eligible for carryover (at the time of the transfer of property to ConRail) to be extended beyond the normal expiration date,<sup>3</sup> but only for use by the transferor against any future income arising from awards of the courts and the redemption of certificates of value. Literally, the language of these rules (sec. 374(e) (1) (A)) required that net operating loss carryovers which were extended could not be applied to income arising from the certificates of value received by any corporation other than the corporation which had originally received these certificates.

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<sup>1</sup> The facilitating legislation for the transfers was the Regional Rail Reorganization Act of 1973 (P.L. 93-236, approved January 2, 1974) and the Railroad Revitalization and Regulatory Reform Act of 1976 (P.L. 94-210, approved February 5, 1976).

<sup>2</sup> P.L. 94-253, approved March 31, 1976.

<sup>3</sup> Under present law, the transferor railroads are generally entitled to 5-year carryover periods for these losses.

### ***Reasons for change***

Since the Congress last considered the tax aspects of the ConRail reorganization in 1976, a problem involving the treatment of the transferor railroads was brought to its attention.

In this situation, an affiliated group of transferor corporations filed consolidated income tax returns for a number of years preceding the April 1, 1976, ConRail transfer and have sizable consolidated net operating loss carryovers which are eligible for the special extended carryover period. Many of the subsidiaries in this group transferred all of their railroad assets to ConRail and presently hold as their only assets the certificates of value or the right to receive these certificates. The parent corporation would like to simplify the corporate structure by merging or liquidating many of its now nonoperating subsidiaries into other members of the group. However, the language of the existing Code provision appeared to prevent the use of the extended net operating loss carryovers against income from the certificates of value because the surviving corporation which receives the certificates of value in a merger or liquidation would not be the original recipient of the certificates.

The Act corrects this un contemplated result arising from the ConRail reorganization.

### ***Explanation of provision***

The Act amends Code section 374(e) (1) (A) (iv) <sup>4</sup> to allow the use of expired net operating loss carryovers against income which is realized from ConRail certificates of value by a member of an affiliated group of corporations (as defined under Code section 1504) where the certificates were originally issued to another corporation which was, on March 31, 1976 (immediately prior to the transfer of assets to ConRail), a member of the same affiliated group.<sup>5</sup>

### ***Effective date***

These amendments apply to taxable years ending after March 31, 1976.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million for the five-year period, fiscal years 1979 through 1983.

<sup>4</sup> This provision was added to the Revenue Act of 1978 by a Senate Finance Committee amendment. The provision was included in a separate bill, H.R. 10653, which was reported by the House Ways and Means Committee (H. Rept. No. 95-1539, September 6, 1978) and was passed by the House on October 3, 1978.

<sup>5</sup> The statutory provision refers to an affiliated group for a taxable year which included March 31, 1967. The date intended for this purpose was March 31, 1976. The year 1967 under the statute resulted from a clerical error.

## **10. Income From Certain Railroad Rolling Stock Treated as From Sources Within the United States (sec. 370 of the Act and sec. 861 of the Code)**

### ***Prior law***

The source of income or loss from the rental of personal property generally depends on whether the property is used inside or outside the United States. Under prior law, where railroad rolling stock was leased to U.S. railroads and the railroad cars were used on a temporary basis in Canada or Mexico, the amount of the income or loss derived by the lessor of the rolling stock which was treated as from U.S. sources and the amount which was treated as from foreign sources was determined by prorating that income or loss in accordance with the amount of time the rolling stock was physically inside and outside the United States during the year.

Typically, under a lease financing of railroad rolling stock (i.e., the rolling stock is purchased by a financial institution and leased to the railroad), the lease produces a tax loss during its early years to the lessor (primarily as a result of accelerated depreciation or amortization deductions). Under prior law, where the rolling stock was used in Canada or Mexico, the loss arising on the lease for the period during which the rolling stock was in those countries was considered to be a foreign source loss under the generally applicable source rules. The characterization of the loss as foreign source operated to reduce the lessor's foreign source taxable income and thus its foreign tax credit limitation. Under certain circumstances, this may have caused the lessor to lose a foreign tax credit, to which it would otherwise be entitled, for foreign taxes paid with respect to its other foreign operations. As a result, this type of lease-financing transaction could be less attractive than a lease-financing transaction involving equipment to be used exclusively in the United States.

Ships and aircraft are financed through similar long-term leases from financial institutions, and lessors expressed similar concern about the loss of foreign tax credits. Under the Revenue Act of 1971, lessors of certain ships and aircraft were given an election to treat all income and loss from the rental of the ships or aircraft as from sources within the United States (Code sec. 861(e)).

### ***Reasons for change***

In recent years, lease financing of railroad rolling stock has become increasingly widespread. Because of the potential loss of foreign tax credits if the leased equipment is used in Canada or Mexico, some financial institutions required indemnity provisions to be inserted in the leases under which the lessee railroads were required to bear the cost of any adverse tax consequences to the lessor which resulted from the use of the leased equipment outside the United States. The potential liability under these indemnity provisions deterred lessees from

allowing the lease-financed rolling stock to be used outside the United States and therefore resulted in inefficient utilization and routing of the rolling stock. The Congress believed that modification of the source rules for rental income and loss from rolling stock would prevent the potential loss of lessors' foreign tax credits if the rolling stock is used outside the United States and would permit lessees to be more flexible in their utilization of the rolling stock.

### ***Explanation of provision***

The Act modifies the source rules applicable to income and loss from the rental of railroad rolling stock.<sup>1</sup> In general, if a lessor leases rolling stock to a United States railroad, and if it is expected that the leased rolling stock will be used predominantly within the United States, then all income or loss of the lessor with respect to the leased railroad rolling stock (including gain from the sale or other disposition of the railroad rolling stock) is to be treated as income or loss from sources within the United States. For this purpose, a United States railroad is a domestic common carrier by railroad or a corporation which is controlled, directly or indirectly, by one or more of those common carriers. The requirement of predominant use in the United States is not satisfied unless the only use outside the United States is use by a person (whether or not a United States person) in Canada or Mexico on a temporary basis which is not expected to exceed a total of 90 days in any taxable year of the lessor.

The provision applies only to railroad rolling stock which is "section 38 property" (or would be section 38 property if not used by certain governmental units). "Section 38 property" is property eligible for the investment tax credit.

The provision does not apply to a lease between two members of the same controlled group of corporations if any member of the group is a domestic common carrier by railroad or a switching or terminal company owned by such a carrier or carriers. This is to prevent a taxpayer which owns the cars from leasing them to a related taxpayer to obtain the benefit of the modified source rules under the provision.

No foreign tax credit is to be allowed to the lessor for any payments to foreign countries with respect to any amount received with respect to railroad rolling stock which is subject to the special source rules under the provision. The Congress believed that if the rental income from these cars is to be treated as from U.S. sources, no foreign tax credit should be allowed for the foreign taxes paid on it. At present, no foreign taxes are imposed on rental income which would be subject to the modified source rules under the provision.

### ***Effective date***

The provision applies to all rolling stock leased to U.S. railroads and placed in service with respect to the lessor after the date of enactment (November 6, 1978). At the election of the lessor, the provision also applies, for taxable years beginning after the date of the enact-

<sup>1</sup> This provision was added to the Revenue Act of 1978 by a Senate floor amendment. The provision was the subject matter of a separate bill, H.R. 12352, which was reported by the House Ways and Means Committee (H. Rept. 95-1561, September 12, 1978), and was passed by the House on September 25, 1978.

ment, to all rolling stock leased to U.S. railroads and placed in service with respect to the lessor on or before the date of enactment. The election may not be revoked except with the consent of the Treasury Department.

***Revenue effect***

This provision will not result in any significant decrease in budget receipts for fiscal years 1979 through 1983.

## **11. Net Operating Losses Attributable to Product Liability Losses (sec. 371 of the Act and sec. 172 of the Code)**

### ***Prior law***

Net operating losses incurred in a taxable year generally may be "carried back" and offset against taxable income of the 3 years first preceding the year of loss and, if not fully absorbed, "carried forward" and offset against taxable income of the 7 years next succeeding the year of loss. Losses offset against taxable income in carryback years generally result in tax refunds, and losses offset against taxable income in future years generally result in decreases in tax liabilities for those years.

### ***Reasons for change***

The Congress believed that an extended carryback period should be available to taxpayers who suffer product liability losses because such losses may tend to be large and sporadic. It was believed that the extended carryback period would reduce the likelihood that a large product liability claim would give rise to a net operating loss in excess of taxable income during the carryback period. Furthermore, the extended carryback period makes it more likely that businesses which suffer product liability losses will obtain a current economic benefit from a tax refund rather than having to speculate on possible future tax reductions due to carryovers of net operating losses.

### ***Explanation of provision***

Under the Act, the amount of a net operating loss that is attributable to a product liability loss can be carried back an additional 7 years. Thus, in total, the product liability loss can be carried back to the 10 years first preceding the loss year and carried forward to the 7 years next succeeding the loss year. A taxpayer can elect not to apply this special carryback rule and, instead to carry the entire net operating loss back 3 years and forward 7 years as under present law. The amount of a net operating loss that is attributable to a product liability loss is the lesser of (1) the sum of the expenses attributable to product liability which are deductible for the taxable year, or (2) the net operating loss (reduced by any portion thereof that is attributable to a foreign expropriation loss) for the taxable year.<sup>1</sup>

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<sup>1</sup> The operation of this rule is illustrated as follows: Assume a taxpayer incurs a net operating loss for the taxable year of \$80,000, of which \$60,000 is attributable to product liability. Assume further that taxable income for each of the 10 years immediately preceding the loss year is \$5,000. The product liability loss of \$60,000 may first be carried back to the 10th through the 4th preceding years, thus absorbing \$35,000 of the loss. The remaining \$25,000 of product liability loss is added to the "regular" net operating loss of \$20,000 (for a total of \$45,000) and is carried to the 3rd through 1st preceding years, which utilizes \$15,000 of the loss. The remaining loss (\$30,000) is carried forward to future years under existing rules, without regard to the source of the loss. Of course, in computing the amount of loss that may be carried from one preceding year to another, the normal adjustments under section 172 (such as the adjustment for the capital gain exclusion or excess of nonbusiness deductions over nonbusiness income) would continue to be applicable even in the extended carryback years.

Product liability losses include not only the liability for damages under product liability claims, but also the expenses incurred in the investigation or settlement of, or opposition to, product liability claims. Indirect corporate expense, or overhead, is not to be allocated to product liability claims so as to become a product liability loss. Only expenses directly incurred in connection with a product liability claim are to be included in determining the amount of the product liability losses for the year.

The definition of product liability under the Act is intended to include the kinds of damages that are recoverable under prevalent theories of product liability. The laws of the several states regarding product liability are not uniform, but it is believed that the definition of product liability provided in the Act is sufficiently broad to encompass the kinds of damages that may be recovered under product liability theories in most states. If a type of injury or damage is included within the Act's definition (such as emotional harm without physical injury) it is to be considered a product liability loss (assuming it otherwise qualifies) even though it may not be recoverable under State law. Thus, if a taxpayer settles out of court on such a claim, the payment may be classified as a product liability loss even though the law of the State would not then have allowed recovery.

The definition of product liability in the Act does not include liabilities arising under warranty, which essentially are contract liabilities.<sup>2</sup> Nor does the definition include liabilities based on services performed by the taxpayer. For example, medical or legal malpractice is not a product liability under the definition.<sup>3</sup> Where both product and services are an integral part of the transaction, such as in the sale and installation of a boiler by the taxpayer, no product liability arises under the definition until all operations have been completed (or terminated) and the taxpayer has relinquished possession of the product. If the loss occurs prior to that point in time, it is not a product liability loss under the definition.

The Act also makes it clear that self-insurance of product liability risks is a business need for which earnings and profits may be accumulated to a reasonable extent without imposition of the tax on unreasonable accumulation of earnings. This provision is consistent with, and merely clarifies, present law. Under the Act, the Secretary of the Treasury will prescribe regulations regarding the determination of the amount that may reasonably be accumulated to meet product liability self-insurance needs. It is expected that the regulations will provide that in determining what is a reasonable accumulation, it is appropriate to take into account the taxpayer's product liability expe-

<sup>2</sup> For example, the costs incurred by a taxpayer in repairing or replacing defective products under the terms of a warranty, express or implied, are not product liability losses. On the other hand, the taxpayer's liability for damages to other property or persons attributable to a defective product may be product liability losses.

<sup>3</sup> Amounts paid for malpractice claims or judgments related to professional services, as well as certain ancillary legal and court expenses, which arise from allegedly negligent acts, may be deductible currently as business expenses under section 162 of the Code. Rev. Rul. 78-210, 1978-23 I.R.B. 8.

In addition, a trust created by a tax-exempt hospital to accumulate and hold funds designated for use to satisfy malpractice claims may qualify for a section 501(c)(3) tax exemption. Rev. Rul. 78-41, 1978-5 I.R.B. 9.

rience, the extent of its commercial coverage for product liability, and the tax consequences of the taxpayer's ability to deduct product liability losses and related expenses for income tax purposes. Estimates of product liability claims that may be made against the taxpayer in the future must be reasonable both as to probability of occurrence and amount.

***Effective date***

This provision is effective for taxable years beginning after September 30, 1979.

***Revenue effect***

This provision will have a negligible effect on budget receipts in fiscal years 1979 and 1980. It will reduce budget receipts by \$9 million in fiscal year 1983.



## **12. Tax Treatment of Returns of Magazines, Paperbacks, and Records (sec. 372 of the Act and new sec. 458 of the Code)**

### ***Present law***

Generally, sellers of merchandise who use an accrual method of accounting must report sales proceeds as income for the taxable year when all events have occurred which fix the right to receive the income and the amount can be determined with reasonable accuracy (Treas. Regs. sec. 1.451-1(a)).

In some cases, the seller expects that accrued sales income will be reduced on account of events subsequent to the date of sale, such as returns of unsold merchandise for credit or refund pursuant to a pre-existing agreement or understanding between the seller and the purchaser. In these instances, the reduction in sales income generally may be recognized only in the taxable year during which the subsequent event, such as the return of unsold merchandise, occurs. Deductions or exclusions based on estimates of future losses, expenses, or reductions in income ordinarily are not allowed for Federal income tax purposes.

Under these general tax accounting rules, the Internal Revenue Service has taken the position that accrual-basis publishers and distributors of magazines, paperbacks, or records must include the sales proceeds of these items in income when they are shipped to the purchaser, and may reduce income for returned items only in the taxable year the items actually are returned unsold by the purchaser.

### ***Reasons for change***

Publishers and distributors of magazines, paperbacks, and records often sell more copies of their merchandise than it is anticipated will be sold to consumers. This "overstocking" is part of a mass-marketing promotion technique, which relies in part on conspicuous display of the merchandise and ability of the retailer promptly to satisfy consumer demand. Publishers usually bear the cost of such mass-marketing promotion by agreeing to repurchase unsold copies of merchandise from distributors, who in turn agree to repurchase unsold copies from retailers. These unsold items are commonly called "returns".

The generally accepted method of accounting for returns in the publishing industry is to record sales at the time merchandise is shipped and to establish an offsetting reserve for estimated returns. The effect of this accounting treatment is to report sales net of estimated returns. Tax accounting rules, however, do not permit gross income to be reduced for returns until the returned items are received, which may not occur until a taxable year subsequent to that in which the sale was recorded.

The Congress concluded that the present method of tax accounting for returns of magazines, paperbacks, and records does not accurately measure income for Federal income tax purposes and that it adversely affects publishers and distributors of these items.

## ***Explanation of provision***

### *General*

For taxpayers who account for sales of magazines, paperbacks, or records on an accrual method, the Act provides an election to exclude from gross income for a taxable year the income attributable to unsold merchandise returned within a certain time (the "merchandise return period") after the close of the taxable year (new sec. 458 of the Internal Revenue Code).<sup>1</sup> In the case of magazines, the merchandise return period extends for 2 months and 15 days after the close of the taxable year. In the case of paperbacks and records, the merchandise return period extends for 4 months and 15 days after the close of the taxable year.<sup>2</sup>

### *Scope of election*

The election applies only with respect to sales of magazines, paperbacks, and records. The term "magazine" includes other periodicals, but does not include newspapers. The term "paperback" means paperback books, which are characterized by a flexible outer cover to which the pages of the book are directly affixed. This method of binding distinguishes paperbacks from hardback books, which usually have stiff front and back covers enclosing pages which are bound to a separate spine. (If an item satisfies the definitions both of magazines and of paperbacks, it is to be treated as a paperback for purposes of the Act.) The term "record" means a disc, tape, or similar object on which musical, spoken, or other sounds are recorded; however, the election does not apply to blank records, tapes, etc., on which it is expected the purchaser will make his or her own recordings.

An election applies with respect to the trade or business in connection with which the magazines, paperbacks, or records are sold. If two or more such categories of merchandise are sold in connection with the same trade or business, each category is treated as a separate trade or business. For example, if a taxpayer sells both magazines and paperbacks in connection with a single trade or business, then solely for purposes of the merchandise-return election the sale of magazines will be considered one trade or business, and the sale of paperbacks will be considered a separate trade or business. With respect to any such separate trade or business, an election applies to all sales of merchandise items in that trade or business (e.g., to all sales of all magazines by an electing taxpayer who publishes several magazines within the same trade or business).

### *Requirements for application*

The method of accounting provided for under the election differs from that used for financial reporting purposes, in that the amount of reduction in gross income pursuant to the election is limited by actual returns during the merchandise return period, while under

<sup>1</sup> This provision was added to the Revenue Act of 1978 by a Senate floor amendment. The provision was the subject matter of a separate bill, H.R. 3050, which was reported by the House Ways and Means Committee (H. Rept. No. 95-1091, May 1, 1978) and was passed by the House on May 23, 1978. The provision was also reported by the Senate Finance Committee as part of H.R. 3050, as amended (S. Rept. 95-1278, October 5, 1978).

<sup>2</sup> Under regulations to be issued by the Treasury Department, an electing taxpayer may select a shorter merchandise return period than that otherwise applicable. Any change in the merchandise return period after its initial establishment will be treated as a change in method of accounting, subject to the rules applicable to such changes.

financial accounting rules, the reduction may be based on an estimate of future returns. Accordingly, several requirements are established to define those returns which may be used to reduce gross income if a timely election is made.

*Legal obligation.*—The taxpayer must be under a legal obligation (as determined by applicable State law), at the time of sale, to adjust the sales price of the magazine, paperback, or record on account of the purchaser's failure to resell it. Cash refunds, credits to the account of the purchaser, and repurchases of the merchandise constitute adjustments of the sales price. However, a markdown of the sales price, such as a refund or credit to the account of the purchaser of only a portion of the sales price under an arrangement whereby the purchaser may continue to hold the merchandise for sale or other disposition (other than solely as scrap), does not constitute an adjustment to the sales price for this purpose.

*Failure to resell.*—The adjustment to the sales price must be on account of the purchaser's failure to resell the magazine, paperback, or record in its trade or business. Adjustments attributable to damage of the merchandise do not qualify as reductions in gross income pursuant to a merchandise-return election. However, items returned under an obligation to adjust the sales prices of unsold merchandise qualify regardless of the fact that the returned magazines, paperbacks, or records may be damaged.

*Return of merchandise.*—A reduction in gross income may be made under a merchandise-return election only with respect to merchandise which has been returned to the taxpayer by the close of the merchandise return period. This return requirement may be satisfied by physical return of the merchandise or by other means to be prescribed by regulations to be issued by the Treasury Department.

Rather than requiring return of the entire magazine for an adjustment to the sales price, some publishers and distributors require only that the cover be cut off and returned, and that the rest of the magazine be disposed of. In these instances, the regulations could provide that certification from the purchaser that such magazines have not been resold and will not be resold constitutes evidence in lieu of physical return. Any permitted certification or other evidence must be acceptable to the Treasury Department as satisfactory proof of the quantity and time of returns. Either the physically returned merchandise or the allowable substituted evidence must be in the possession of the taxpayer at the close of the merchandise return period.

#### *Amount to be excluded*

The amount to be excluded from gross income on account of otherwise qualifying returns is limited to the lesser of (1) the amount covered by the acknowledged legal obligation with respect to such returns or (2) the amount of adjustment to the sales price agreed to by the taxpayer before the close of the merchandise return period. An agreement to adjust the sales price may be evidenced by the taxpayer's making an actual refund or credit to the account of the purchaser, or by the taxpayer's issuing a credit memorandum or other document stating such amount credited to the purchaser.

If the amount of legal obligation with respect to such returns is in dispute at the close of the merchandise return period, the amount in dispute cannot be excluded from gross income. For this purpose, the amount in dispute is the difference between the merchandise-return

amount asserted to be due from the taxpayer and the lesser of the amount covered by the acknowledged legal obligation with respect to such returns or the amount of adjustment to the sales price agreed to by the taxpayer before the close of the merchandise return period.

### *Method of making election*

A merchandise-return election does not require consent of the Treasury Department, but must be made in such manner as the Department may prescribe by regulations. The election for a particular taxable year must be made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof); the election cannot be made on an amended return filed after the due date (including extensions thereof) for filing the return for such taxable year. Once made, an election is binding for future years with respect to the particular trade or business to which the election applies (e.g., sales of magazines) unless the taxpayer secures consent of the Treasury Department to revoke it.

### *Election as method of accounting; transitional adjustments*

The computation of income under the merchandise-return election constitutes a method of accounting.<sup>3</sup> In the absence of a specific statutory rule to the contrary, an adjustment to income attributable to a change in method of accounting (called the "transitional adjustment") is amortized over a set period of time prescribed by the Internal Revenue Service, usually 10 years (sec. 481(c)). However, this provision sets forth specific rules for the transitional adjustments arising out of merchandise-return elections.

In the case of an election to account for magazine returns under this provision, a special 5-year amortization of the transitional adjustment is provided in place of the normal 10-year amortization. In the case of an election to account for paperback or record returns under this provision, the provision establishes a "suspense account" to hold the transitional adjustment. The operative effect of the suspense account (described in detail below) is to defer deduction of the transitional adjustment until the taxpayer is no longer engaged in the trade or business of selling the items which were the subject of an election.

To the extent that this provision of the Act sets forth special rules applicable to computation of income under a merchandise-return election (such as the transitional adjustment rules) which are inconsistent with the rules generally applicable to changes in method of accounting, the special rules of this provision override. For example, the provision authorizes an initial merchandise-return election to be made without consent of the Treasury Department, which also is inconsistent with the general rule on changes in method of accounting. However, other rules under present law relating to accounting changes will continue to apply, such as the requirement of recognizing the balance of a deferred adjustment if the taxpayer ceases to be engaged in the trade or business to which it relates.

<sup>3</sup> Thus, a change to another method of reporting merchandise returns would be a change in method of accounting subject to the applicable rules governing accounting changes. As stated in note 2, *supra*, a change in the merchandise return period after its initial establishment also constitutes a change in method of accounting.

### *Suspense account for paperbacks and records*

A separate suspense account is to be established for each trade or business (or category which is treated as a trade or business under this provision) with respect to which an election is made. As long as merchandise returns during the merchandise return period remain at or below the level of the initial opening balance in the account, taxable income under the merchandise-return method is the same as it would have been absent an election. However, an increase in returns over the initial opening balance is recognized one year earlier under the elected method.

*Initial opening balance.*—To compute the initial opening balance of the suspense account for the first taxable year for which an election is effective, the taxpayer must determine the dollar amount of merchandise returns which would have been excluded from gross income for each of the three preceding taxable years as if the election had been in effect for those years. The initial opening balance of the account is the largest such dollar amount determined for any one of the three prior years. If that initial opening balance exceeds the actual returns during the merchandise return period following the close of the year immediately preceding the year of election, such excess is included in income in the year of election. Section 481(b) does not apply to this increase in the suspense account.

For example, assume that a paperback distributor made a timely merchandise-return election effective for its taxable year ending December 31, 1980, and did not select a merchandise return period shorter than the statutory period. If the taxpayer's merchandise returns in the first 4 months and 15 days of 1978, 1979, and 1980 were \$5, \$8, and \$6 respectively, then the initial opening balance in the suspense account on January 1, 1980 would be \$8 (the largest dollar amount of merchandise returns in the pertinent years).<sup>4</sup> Since the initial opening balance exceeds the actual returns in the first 4 months and 15 days of the taxable year for which the election is first effective (\$6 in 1980), the excess of \$2 is added to gross income for such taxable year (1980).

*Annual adjustments.*—Adjustments are made to the suspense account each year to account for fluctuations in returns. To compute the annual adjustment, the taxpayer must determine the amount to be excluded from gross income for the taxable year under the election. If this amount is less than the opening balance in the suspense account for the taxable year, the account is reduced by the difference. Conversely, if such amount is greater than the opening balance in the suspense account for the taxable year, the account is increased by the difference (but not to an amount in excess of the initial opening balance). Adjustments which reduce the suspense account reduce gross income for the taxable year; adjustments which increase the suspense account increase gross income for the taxable year.

Assume, in addition to the facts of the example given above, that qualifying returns in the first 4 months and 15 days of 1981, 1982, and 1983 are \$5, \$7, and \$10 respectively. Under these facts, the opening balance for 1981 would be \$5. This equals the \$8 initial opening balance for 1980 reduced by \$3, which is the excess of the initial opening bal-

<sup>4</sup> In the example, the three years prior to the taxable year (calendar 1980) are 1977, 1978, and 1979. Accordingly, the merchandise-return periods for those years (as if the election had then been in effect), in the case of paperbacks, are the first 4 months and 15 days of 1978, 1979, and 1980.

ance (\$8) over merchandise returns in the first 4 months and 15 days of 1981 (\$5).

The amount excludable from gross income under the election for 1981 is \$7, i.e., the amount of qualifying returns in the first 4 months and 15 days of 1982. Since the excludable amount (\$7) exceeds the opening balance for 1981 (\$5), the account is increased by \$2 to \$7, and \$2 is added to gross income for the year. Thus the net amount excludable from income in 1981 after these adjustments is \$5—the \$7 exclusion netted against the \$2 addition to gross income.

The amount excludable under the election for 1982 is \$10, which is \$3 more than the \$7 opening balance in the suspense account for 1979. However, the suspense account is increased only by \$1 to \$8, the initial opening balance (and ceiling on the suspense account). The \$1 also is added to gross income for the year. The net amount excludable from income in 1982 after all adjustments is \$9.

*Comprehensive illustration.*—This example is set out more fully for the years 1980 through 1983 in the following table.

	Years Ending Dec. 31					
	1978	1979	1980 <sup>1</sup>	1981	1982	1983
<i>Facts:</i>						
Actual returns in first 4 months and 15 days-----	\$5	\$8	\$6	\$5	\$7	\$10
<i>Adjustment to suspense account:</i>						
Opening balance-----			\$8	\$5	\$7	\$8
Addition to account <sup>2</sup> -----				2	1	
Reduction to account <sup>3</sup> -----			(3)			
Opening balance for next year-----			\$5	\$7	\$8	\$8
<i>Amount excludable from income:</i>						
Initial year adjustment-----			\$(2)			
Amount excludable as actual returns in merchandise return period-----			5	\$7	\$10	
Adjustment for increase in suspense account-----				(2)	(1)	
Adjustment for decrease in suspense account-----			3			
Net amount excludable for the year-----			\$6	\$5	\$9	

<sup>1</sup> Year of change.

<sup>2</sup> Applies when returns during the merchandise return period exceed the opening balance; the addition is not to cause the suspense account to exceed the initial opening balance.

<sup>3</sup> Applies when returns during the merchandise return period are less than the opening balance.

*Nonrecognition transactions.*—When a taxpayer who is required to maintain a suspense account under this election is a party to a transaction with respect to which there is nonrecognition of gain or loss to any party to the transaction by reason of subchapter C of the Code, the operation and continuation of the suspense account is to be determined in accordance with regulations to be prescribed by the Treasury Department.

***Effective date***

The election provided by this provision of the Act may be made with respect to taxable years beginning after September 30, 1979.

***Revenue effect***

This provision will reduce budget receipts by \$5 million in fiscal year 1980, \$11 million in fiscal year 1981, and \$13 million in fiscal year 1983.

### 13. Tax Treatment of Redemptions of Discount Coupons (sec. 373 of the Act and new sec. 466 of the Code)

#### *Prior law*

Under a Treasury regulation (§ 1.451-4) specifying the appropriate taxable year for inclusion of income items, accrual-basis issuers of premium coupons with sales may reduce gross receipts by the estimated cost of redeeming such coupons outstanding at the close of the taxable year (plus the cost of redeeming coupons during the taxable year that have not previously been taken into account). The term "premium coupon" is not defined in the regulation, and the courts have not directly addressed the question of what constitutes a premium coupon.

The Internal Revenue Service has ruled that two types of "cents-off" or "discount" coupons do not qualify under the regulation for the estimated deduction.<sup>1</sup> The two types are called "media coupons" and "in pak/on pak coupons". Media coupons are issued gratuitously through the mail or by newspaper, etc., while in pak/on pak coupons are included with merchandise purchased by the consumer. Both types allow the consumer "cents off" (or other discount) on the purchase price of specified merchandise.

Another income tax regulation (§ 1.461-1(a)(2)) provides that an accrual-basis taxpayer may accrue and deduct an expense in the taxable year in which all the events have occurred that fix the fact of the liability and the amount can be determined with reasonable accuracy. This is called the "all events" test. Under this rule, an accrual method taxpayer generally can accrue and deduct the cost of redeeming discount coupons tendered for redemption by the close of the taxable year. Further, it could be argued that a deduction may be claimed under this rule when the coupon is tendered for redemption to a person authorized to redeem it from the consumer.

#### *Reasons for change*

For many years, trading stamps and premium coupons have been employed as a means of promoting the sale of many products. However, in recent years an increasing number of companies have been using discount coupons to promote their merchandise.<sup>2</sup>

<sup>1</sup> Rev. Rul. 73-415, 1973-2 C.B. 154, and Rev. Rul. 78-212, I.R.B. 1978-23, p. 11.

<sup>2</sup> A typical discount coupon promotion program would operate in the following manner. Assume that a manufacturer of cereal desires to promote a new brand of cereal beginning October 1 of the current year. During September, the manufacturer sells large quantities of the new cereal to retailers so that they will have sufficient inventory on hand during the promotion period. The manufacturer also arranges to have coupons, allowing 50 cents off on the purchase of a box of the new cereal, distributed by newspaper, by direct mail, and by inclusion in packages of other products sold by the manufacturer.

Before the end of December (the close of the manufacturer's taxable year), perhaps as many as 75 percent of the coupons that will ultimately be redeemed will be tendered to retailers by consumers. The manufacturer, however, may not receive these coupons from the retailers for several months. This time lag between receipt by the retailer and redemption by the manufacturer occurs because the coupons usually go through a redemption process that includes grouping, counting, and verification by both the retailer and an intermediary party called a "redemption agent."



The regulation presently governing the tax accounting treatment for trading stamps and premium coupons does not specifically address the method of accounting for discount coupons. It is argued by some that no real distinction can be drawn between premium coupons and discount coupons, and that the principles of the regulation apply equally to both types.

Industries that rely heavily on discount coupons for product promotion have testified before the Congress that they consistently have been using the accounting treatment provided in the trading stamp and premium coupon regulation for discount coupons. Accordingly, the IRS rulings that deny to certain types of discount coupons the accounting treatment provided in the regulation for trading stamps and premium coupons have caused confusion and uncertainty in industries that rely heavily on discount coupon promotions.

The Congress concluded that it is appropriate to allow a limited deduction for discount coupons estimated to have been turned in by consumers by the close of the issuer's taxable year, but which have not been received by the issuer by that time. This treatment is essentially in accord with the rule that allows a deduction under the "all events" test of present law, if the amount of deduction can be determined with reasonable accuracy. The Act resolves the reasonable accuracy issue and the certainty needed for administration by providing, generally, that a deduction will be allowed for coupons outstanding at the close of the taxable year that are received by the issuer within six months after the close of the taxable year.

### ***Explanation of provision***

#### ***General***

For taxpayers who use an accrual method of accounting, the Act provides an election to deduct the cost of redeeming qualified discount coupons outstanding at the close of the taxable year and received by the taxpayer within the "redemption period," which generally is the six-month period following the close of the taxable year<sup>3</sup> (new sec. 466 of the Internal Revenue Code).<sup>4</sup>

#### ***Coupons for which election may be made***

The election applies only with respect to qualified discount coupons. The income tax accounting treatment of trading stamps and premium coupons presently provided in Treasury regulation § 1.451-4 is not changed by this provision of the Act, and the enactment of this provision does not imply that the tax accounting treatment accorded trading stamps and premium coupons under regulation § 1.451-4 is improper.

To the extent (if any) that regulation § 1.451-4 applies to qualified discount coupons, this provision of the Act supersedes the regulation and provides, as of the effective date of this provision, the sole accrual accounting method of deducting the cost of redeeming qualified dis-

<sup>3</sup> An electing taxpayer may select a redemption period shorter than six months. And change in the redemption period after its initial establishment is a change in method of accounting, subject to the rules applicable to such changes.

<sup>4</sup> This provision was added to the Revenue Act of 1978 by a Senate floor amendment. The provision was the subject matter of a separate bill, H.R. 13047, which was reported by the House Ways and Means Committee (H. Rept. No. 95-1707, October 4, 1978) and was passed by the House on October 13, 1978.

count coupons outstanding at the close of the taxable year. Also, discount coupons which are not "qualified discount coupons" under the provision are not accorded the tax accounting treatment provided by the provision, nor are they to be accorded the tax accounting treatment provided by the trading stamp and premium coupon regulation. The proper taxable year in which to deduct the cost of redeeming discount coupons which are not "qualified discount coupons" under the provision is to be determined generally under the normal tax accounting rules provided in section 461 of the Code and the regulations thereunder.

The determination of whether a coupon is a premium coupon or discount coupon is to be made by taking into account all the facts and circumstances involving its issuance and redemption. The method of issuance may be one of the facts and circumstances taken into account to determine whether a coupon is a discount coupon or premium coupon (but not to determine whether a discount coupon is a qualified discount coupon).

A premium coupon generally is issued in connection with the sale of some item and entitles the holder to tender it (or, more usually, a large number of such coupons) in exchange for a product, often selected from a catalog, of the consumer's choosing. These coupons are used to promote the sale of the product with which the coupon is issued by allowing the consumer to collect coupons in order to acquire a different product of his or her own choosing.<sup>5</sup>

A discount coupon, on the other hand, usually is designed to encourage the purchase of a specific product by allowing a discount on its purchase price. Discount coupons may be issued in a number of ways, including through newspapers or other printed media, by mail, and printed on or included in the package of another product. The discount may be stated in terms of a cash amount, a percentage of the purchase price, or as a "two for the price of one" coupon. Ordinarily, a discount coupon is individually redeemable, while the premium coupon is intended to be collected and redeemed in large numbers for a single product.

To qualify under the provision, a discount coupon must be (1) issued by the taxpayer, (2) redeemable by the taxpayer, and (3) allow a discount on the purchase price of merchandise or other tangible personal property. Coupons redeemable for a discount on the price of services or real property do not qualify under the provision. A coupon need not be printed on paper in the form usually associated with coupons; it may be a token or other object, so long as it functions as a coupon. A coupon is not a qualified discount coupon if the face amount (including the effective discount of the coupon if it is a "two for the price of one" or "percentage off" coupon) is more than \$5, or if it may be used in connection with other coupons to bring about a price reduction of more than \$5 with respect to any item.

A coupon is not a qualified discount coupon if it is redeemed by the issuer directly from the person using the coupon to obtain a price

<sup>5</sup> A well-known example of a premium coupon is the type of coupon issued with each pack of certain brands of cigarettes.

discount.<sup>6</sup> For purposes of this rule, corporations which are members of the same controlled group of corporations (as defined in section 1563(a) of the Code) as the issuer are treated as the issuer. Thus, a coupon redeemed by a wholly owned subsidiary of the issuer is not a qualified discount coupon if it is redeemed directly by such subsidiary from the user.

*Method of making election and scope of election*

A discount coupon election does not require consent of the Secretary of the Treasury, but must be made in such manner as the Secretary may prescribe by regulations. The election for a particular taxable year must be made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof); the election cannot be made on an amended return filed after the due date (including extensions thereof) for filing the return for such taxable year. Once made, an election is binding for future years with respect to the particular trade or business to which the election applies unless the taxpayer secures consent of the Secretary to revoke it.

The election is made with respect to the trade or business in connection with which the coupons are issued. An election applies to all qualified discount coupons issued by that trade or business.

*Election as method of accounting*

The computation of income under a discount coupon election constitutes a method of accounting. Thus, the election of this method or a change to another method of accounting for discount coupons will be a change in method of accounting subject to the applicable rules governing accounting changes. However, to the extent that this provision sets forth special rules that are inconsistent with the rules generally applicable to changes in method of accounting, the special rules of this provision are to take precedence.

Thus, although an election made under this provision constitutes a change in method of accounting, the special rules of the provision relating to the treatment of the adjustment to taxable income resulting from the election are to take precedence over the general rules. Generally, under these special rules, net decreases in taxable income are deferred from recognition by being placed in a suspense account, and net increases in taxable income are taken into income over a 10-year period. Section 481(b)(2), relating to the computation of tax if there is a substantial increase in taxable income because of an accounting method change, does not apply to an election under this provision.

The method of accounting provided by this provision generally is expected to clearly reflect income. However, if (for example) a taxpayer manipulates the issuance of coupons in such a manner that the rules set forth in this provision of the Act do not result in a clear reflection of income, it is anticipated that the Secretary, within his general authority under section 446 of the Code, may modify the method so that it does clearly reflect income.

<sup>6</sup> The provision is intended to allow a deduction with respect to coupons turned in by the consumer before the close of the issuer's taxable year, but where, because of the time lag inherent in the chain of redemption, the coupons are not received by the issuer until some time after the close of its taxable year. If a coupon is redeemed directly by the issuer, no such time lag exists.

### *Amount of deduction*

Under the election, a taxpayer is allowed a deduction for the cost of redeeming qualified discount coupons outstanding at the close of the taxable year that are received within the "redemption period", which generally is the six-month period following the close of the taxable year. In addition, a deduction is allowed for the cost of redeeming qualified discount coupons received during the taxable year for which a deduction has not been allowed with respect to a redemption period of a previous year. Coupons received by an agent of the taxpayer (other than an agent who accepted the coupon from the person who used it to receive a price discount) before the close of the redemption period qualify as having been received by the taxpayer before the close of such period.

The cost of redeeming a coupon is the amount of discount stated on the coupon or, if less, the amount incurred by the taxpayer for paying the discount, plus an amount payable to the retailer (or other person redeeming the coupon from the person receiving the price discount) for services in redeeming the coupon. The amount payable to the retailer or other person for services in redeeming the coupon is allowed only if the amount payable is stated on the coupon. The amount incurred by the taxpayer in paying the discount does not include incidental costs such as a redemption center service fee.

### *Suspense account*

In the absence of a specific statutory rule to the contrary, an adjustment to income attributable to a change in method of accounting (called the "transitional adjustment") is amortized over a set period of time prescribed by the Internal Revenue Service, usually 10 years (sec. 481(c)). Instead of using this general rule, the Act provides two special rules for the treatment of the transitional adjustment. If the adjustment is a net decrease in taxable income, it is to be placed in a suspense account. If it is a net increase in taxable income, it is to be taken into income ratably over a 10-year period beginning with the year of change.

The effect of the suspense account, which is described in detail below, is to defer the deduction of the transitional adjustment until the taxpayer is no longer engaged in the trade or business in connection with which the discount coupons are issued. A separate suspense account is to be established for each trade or business with respect to which an election is made.

*Initial opening balance.*—To compute the initial opening balance of the suspense account for the first taxable year for which an election is effective, the taxpayer must determine the dollar amount of the deduction for discount coupons that would have been allowed with respect to coupons redeemed during the redemption period for each of the three preceding taxable years had the election been in effect for those years. The initial opening balance of the account is the largest such dollar amount determined for any one of the three prior years, reduced by the sum of the adjustments attributable to the change in method of accounting that increase income for the year of change. If, in computing the initial opening balance, the largest dollar amount of deduction that would have been allowed in any of the three prior years exceeds the actual cost of redeeming coupons received during the

redemption period following the close of the year immediately preceding the year of election, the excess is included in income in the year of election. Section 481(b) does not apply to this increase in the suspense account.

For example, assume that an issuer of qualified discount coupons makes a timely election under new section 466 for its taxable year ending December 31, 1979, and does not select a coupon redemption period shorter than the statutory period of 6 months. If the taxpayer's qualified coupon redemptions in the first 6 months of 1977, 1978, and 1979 were \$7, \$13, and \$8, respectively (and the accounting change adjustments that increase income for 1979 are \$2), then the initial opening balance in the suspense account on January 1, 1979 would be \$11 (that is, the largest dollar amount of qualified coupon redemptions in the pertinent years (\$13)<sup>7</sup>, reduced by the sum of the accounting change adjustments that increase income in the year of change (\$2)). Since the coupon redemptions taken into account in determining the initial opening balance (\$13 in 1978) exceed the actual redemptions in the first 6 months of the taxable year for which the election is first effective (\$8 in 1979), the excess of \$5 is added to gross income for the year of election (1979).

*Annual adjustments.*—Adjustments are made to the suspense account each year to account for fluctuations in redemptions. To compute the annual adjustment, the taxpayer must determine the amount to be deducted under the election with respect to coupons received during the redemption period applicable to the taxable year under the election.

If this amount is less than the opening balance in the suspense account for the taxable year, the account is reduced by the difference. Conversely, if such amount is greater than the opening balance in the suspense account for the taxable year, the account is increased by the difference (but not to an amount in excess of the initial opening balance). Adjustments that reduce the suspense account are a deduction for the taxable year; adjustments that increase the suspense accounts increase gross income for the taxable year.

To continue the example above, assume that coupon redemptions in the first 6 months of 1980, 1981, and 1982 are \$7, \$10, and \$12, respectively. Given these facts, and applying the rules relating to annual adjustments to the suspense account described above, the annual adjustments to the account for 1979, 1980, and 1981 are a reduction of \$4, increase of \$3, and increase of \$1,<sup>8</sup> respectively. The computation of these adjustments, as well as the net effect of all these adjustments on income for each year, are set out in the following table.

*Illustration.*—This table illustrates the establishment of the suspense account and its operation for the years 1979 through 1981.

<sup>7</sup> In the example, the three years prior to the taxable year (calendar 1979) are 1976, 1977, and 1978. Accordingly, the statutory redemption periods for those years (as if the election had then been in effect) are the first 6 months of 1977, 1978, and 1979.

<sup>8</sup> For 1981, the amount deductible as actual coupon redemptions (for the first six months of 1982) is \$12. The opening balance for 1981 is \$10. The annual adjustment to the suspense account is an increase of only \$1, however, since the account is not to be increased to an amount in excess of the initial opening balance (\$11, in the example). As shown in the illustration, the net amount deductible for 1981 is \$11.

	Years Ending Dec. 31—					
	1977	1978	1979 <sup>1</sup>	1980	1981	1982
<i>Facts:</i>						
Actual coupons redeemed in first six months.....	\$7	\$13	\$8	\$7	\$10	\$12
Accounting change adjustments that increase income in year of change.....			2			
Net adjustment decreasing income in year of change under sec. 481(a)(2).....			\$6			
<i>Adjustment to suspense account:</i>						
Opening balance <sup>2</sup> .....			\$11	\$7	\$10	\$11
Addition to account <sup>3</sup> .....				3	1	
Reduction to account <sup>4</sup> .....			(4)			
Opening balance for next year.....			\$7	\$10	\$11	\$11
<i>Amount deductible:</i>						
Initial year adjustment <sup>5</sup> .....			\$(5)			
Amount deductible as actual coupon redemptions during redemption period.....			7	\$10	\$12	
Adjustment for increase in suspense account.....				(3)	(1)	
Adjustment for decrease in suspense account.....			4			
Net amount deductible for the year for coupons redeemed during the redemption period.....			\$6	\$7	\$11	

<sup>1</sup> Year of change.

<sup>2</sup> The largest dollar amount of deduction that would have been allowed with respect to coupons redeemed within any redemption period of the three years immediately preceding the year of election (\$13), reduced by the accounting change adjustments that increase income in the year of change (\$2).

<sup>3</sup> Applies when coupons redeemed during the redemption period for the taxable year exceed the opening balance; the addition is not to cause the suspense account to exceed the initial opening balance.

<sup>4</sup> Applies when coupons redeemed during the redemption period for the taxable year are less than the opening balance.

<sup>5</sup> The initial year adjustment applies when the initial opening balance is computed with respect to actual coupon redemptions in the first six months of either of the two years preceding the year of change. If the adjustment applies, the amount of adjustment is the excess of the coupons redeemed in the first six months of the applicable year over the coupons redeemed in the first six months of the year of change.

**Nonrecognition transactions.**—If a taxpayer who is required to maintain a suspense account under this election is a party to a transaction with respect to which there is nonrecognition of gain or loss to any party to the transaction by reason of subchapter C of the Code, the operation and continuation of the suspense account is to be determined in accordance with regulations to be prescribed by the Secretary of the Treasury.

### ***Effective date***

#### ***In general***

The provision is effective for taxable years ending after December 31, 1978.

#### ***Special rules for certain prior years***

Under the provision, certain accounting methods for discount coupons used in taxable years ending before January 1, 1979 are to be treated as proper for Federal tax purposes if the taxpayer elects under new Code section 466 for his first taxable year ending after December 31, 1978. To qualify for the benefit of this "protective" election, the taxpayer (1) for a continuous period of one or more prior taxable years (each of which ends before January 1, 1979) must have used a method of accounting for discount coupons that is reasonably similar to the method provided in the trading stamp and premium coupon regulation (§ 1.451-4 or its predecessors under the Internal Revenue Code of 1954) and (2) must elect the provisions of new Code section 466 for the taxpayer's first taxable year ending after December 31, 1978. If a reasonably similar method was used in two or more separate continuous periods, the election may be made only with respect to one such period.

If a taxpayer timely makes such a protective election, then the method of accounting used for such continuous period is to be treated as a valid method of accounting with respect to such discount coupons for the continuous period of one or more taxable years each of which ends before January 1, 1979. The protective election must be made in such manner and form as the Secretary of Treasury prescribes by regulations. Such an election shall be treated for Federal tax purposes as a method of accounting, but does not require consent of the Secretary of the Treasury.

An otherwise qualifying protective election may apply, with respect to the continuous period of taxable years each of which ends before January 1, 1979, to coupons which are discount coupons but which would not be treated as qualified discount coupons under new Code section 466. Also, the cost of redemption center service fees, and amounts which are payable to the retailer (or other person redeeming the coupon from the person receiving the price discount) for services in redeeming the coupons but which are not stated on the coupons, are deductible for prior years covered by a protective election (if treated as deductible under the accounting method for such years), even though such cost and amounts would not be deductible under new Code section 466.

If a taxpayer makes a timely election under these rules to "protect" prior years, and, in addition, the method of accounting used in those

years was used for all discount coupons issued by the taxpayer in those years, then the taxpayer need not establish the suspense account normally required by new Code section 466.<sup>9</sup> Instead, the taxpayer will treat the election of the method under new Code section 466 as a change in method of accounting to which the normal rules for accounting for transitional adjustments apply.

This protective election may be made at any time before the expiration of the period for making the election under new Code section 466 for the taxpayer's first taxable year ending after December 31, 1978.

The Congress recognizes that, due to the Internal Revenue Service interpretation of the trading stamp and premium coupon regulation, some taxpayers may have agreed in a prior year or years to discontinue the use of the regulation to account for discount coupons. If any such year is not closed under the statute of limitations, or by reason of a closing agreement with the Internal Revenue Service, the taxpayer may file a claim for the refund if any, which would be due based on the use of the "protected" method of accounting (assuming he makes the protective election) if he used that method in his original return filed for that taxable year. This is not to be construed, however, to abrogate in any way the rules regarding the closing of taxable years due to the statute of limitations or a binding agreement between the Internal Revenue Service and the taxpayer.

### ***Revenue effect***

This provision will reduce budget receipts by \$103 million in fiscal year 1980, and \$10 million in each of fiscal years 1981, 1982, and 1983. The estimated reduction in budget receipts in fiscal year 1980 includes almost \$100 million attributable to tax liabilities of prior years on the assumption that the position of the IRS with regard to the proper method of accounting for discount coupons under existing law (see footnote 1, *supra*) would be upheld by the courts in 1980.

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<sup>9</sup> The determination of whether the accounting method was used for all discount coupons is not to be made by looking separately at each trade or business of the taxpayer in which discount coupons were issued. The suspense account requirement (otherwise applicable beginning with the electing taxpayer's first taxable year ending after December 31, 1978) is waived only if such accounting method was used for all discount coupons issued by the taxpayer in all its separate trades or businesses in which any discount coupons were issued by the taxpayer during the pertinent period.



## **TITLE IV—CAPITAL GAINS; MINIMUM TAX; MAXIMUM TAX**

### **A. CAPITAL GAINS PROVISIONS**

#### **1. Repeal of Alternative Tax for Noncorporate Capital Gains (sec. 401 of the Act and sec. 1201(b) of the Code)**

##### ***Prior law***

Under prior law, a noncorporate taxpayer could deduct from gross income 50 percent of the amount of any net capital gain for the taxable year. The remaining 50 percent of the net capital gain was included in gross income and taxed at the otherwise applicable regular tax rates.

In lieu of taxing 50 percent of net capital gains at the regular rates, a partial alternative tax of 25 percent on the first \$50,000 of net capital gains was applicable if it resulted in a lower tax rate than that produced by the regular method.

##### ***Reasons for change***

The increase in the noncorporate capital gains deduction from 50 to 60 percent and the modifications in the minimum tax result in a decrease in the highest capital gains tax rate from about 49 percent to 28 percent. Given these changes, the Congress decided that repeal of the alternative tax would simplify the tax law and contribute to tax equity.

##### ***Explanation of provision***

The Act repeals the noncorporate alternative tax for capital gains.<sup>1</sup>

##### ***Effective date***

This provision is effective for taxable years beginning after December 31, 1978.

##### ***Revenue effect***

This provision will increase budget receipts by \$20 million in fiscal year 1979, \$133 million in fiscal year 1980, and \$166 million in fiscal year 1983.

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<sup>1</sup> The Act inadvertently omitted a technical change necessary for the correct calculation of the alternative tax for 1978 capital gains. The alternative tax formula for computing the partial tax on taxable income, reduced by the amount of the net capital gain included in income, should have been conformed to reflect the increase in the capital gains deduction. Thus, section 1201 (b) (1) and (c) of the Code should be read as requiring an adjustment of taxable income by the amount of the includible net capital gains rather than 50 percent of the net capital gains. Without this conforming amendment under section 1201(b) (1), taxable income would be reduced by an amount of capital gains greater than that which was included in income and, under section 1201(c), taxable income would be increased by too large an amount with respect to gains in excess of \$50,000. It is anticipated that this technical error will be corrected by legislation in the 96th Congress.

## **2. Increased Capital Gains Deduction for Individuals (sec. 402 of the Act and sec. 1202 of the Code)**

### ***Prior law***

Under prior law, a noncorporate taxpayer could deduct from gross income 50 percent of the amount of any net capital gain for the taxable year. The net capital gain equals the excess of net long-term capital gains over net short-term capital losses. The remaining 50 percent of the net capital gains was included in gross income and taxed at the otherwise applicable regular tax rates.

### ***Reasons for change***

The Congress believed that the present level of taxes applicable to capital gains has contributed both to a slower rate of economic growth than that which otherwise might have been anticipated, and also to the realization of fewer gains than would have been realized if the tax rates had been lower. In some instances, the taxes applicable to capital gains effectively may have locked some taxpayers into their existing investments. Moreover, the Congress believed that the present level of capital gains taxes had contributed to the shortage of investment funds needed for capital formation purposes generally, and especially for new and small businesses. As a result, the Congress believed that changes were required in the tax provisions applicable to capital gains.

The Congress believed that lower capital gains taxes will markedly increase sales of appreciated assets, which will offset much of the revenue loss from the tax cut, and potentially lead to an actual increase in revenues. In addition, the improved mobility of capital will stimulate investment, thereby generating more economic activity and more tax revenue.

In addition, the Congress believed that an increased capital gains deduction would tend to offset the effect of inflation by reducing the amount of gain which is subject to tax. However, since the deduction is constant, unlike the adjustments generally provided for in various indexation proposals, it is much simpler and should not tend to exacerbate inflation.

The Congress believed that the increased deduction, in conjunction with the Act's other capital gains tax changes and its reformulation of the minimum tax, should contribute significantly to a more favorable economic climate by increasing the mobility of capital, and by providing an incentive for taxpayers to both realize gains and to increase savings. In addition, the provisions relating to the alternative minimum tax (see below) should assure that every individual realizing capital gains pays at least a minimum amount of tax.

### ***Explanation of provision***

The Act provides that a noncorporate taxpayer may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year. The remaining 40 percent of the net capital gain is subject to tax at the otherwise applicable rates.

The Act does not change the present law treatment of a noncorporate taxpayer's capital losses.

The Act coordinates the increased capital gains deduction with the rules applicable to charitable contributions of appreciated property. It provides that the amount of certain charitable contributions of capital gains property is to be reduced by 40, rather than 50, percent of the gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value.

Generally, the increased capital gains deduction is applicable in the case of taxable transactions occurring, and installment payments received, after October 31, 1978. These installment payments generally will qualify for the increased deduction even though they relate to pre-November 1, 1978, transactions.

### ***Effective date***

The increase in the capital gains deduction applies to taxable years ending after October 31, 1978. The change in the rules applicable to charitable donations of property apply to contributions made after October 31, 1978.

The Act contains a special transitional rule for sales or exchanges occurring, and installment payments received, in November or December 1978. Under this rule, the allowable deduction with respect to the taxable year which began prior to November 1, 1978, and which ends after October 31, 1978, is the sum of: (1) 60 percent of the lesser of the net capital gain for the taxable year, or the net capital gain taking into account only post-October 31, 1978 sales, exchanges, and installment payments, and (2) 50 percent of the excess of the net capital gain for the taxable year, over the amount of the net capital gain taken into account under (1).

In the case of long-term capital gains from sales or exchanges by certain conduit or conduit-type entities (partnerships, subchapter S corporations, mutual funds, real estate investment trusts, etc.) before November 1978, it is anticipated that legislation will be considered in the 96th Congress to clarify that such gains are not eligible for the 60 percent deduction although they are includible in income by individuals for 1979 because the entities have fiscal years ending in 1979.

### ***Revenue effect***

This provision will reduce budget receipts by \$131 million in fiscal year 1979, \$1,763 million in fiscal year 1980, and \$2,190 million in fiscal year 1983.

### **3. Reduction of Corporate Alternative Tax for Capital Gains Tax (sec. 403 of the Act and sec. 1201 of the Code)**

#### ***Prior law***

Under prior law, an alternative tax of 30 percent applied to corporate net capital gains (the excess of net long-term capital gain over net short-term capital loss) if that rate was less than the corporation's regular tax rate. The maximum regular corporate tax rate was 48 percent. No special deduction for any amount of a long-term capital gain is available to corporations.

#### ***Reasons for change***

The Congress believed that a reduction in the corporate alternative tax rate was appropriate to provide corporate capital gains with the same tax differential in effect with respect to the maximum corporate regular income tax rate, which the Act reduces from 48 percent to 46 percent. The Congress believed that a reduced corporate capital gains tax rate will contribute to an improved economic climate both through an increased corporate ability to provide internal sources of capital, and by making additional funds available for distribution to shareholders.

#### ***Explanation of provision***

The Act reduces the corporate alternative tax rate from 30 to 28 percent and makes a number of conforming changes in other provisions.

#### ***Effective date***

This provision generally applies to taxable years ending after December 31, 1978.

A transitional rule is provided for fiscal year taxpayers with respect to sales or exchanges occurring after December 31, 1978 in the fiscal year ending in 1979. Under this rule the corporate alternative tax is the sum of: (1) 28 percent of the lesser of the net capital gain for the year, or the net capital gain from post-December 31, 1978 sales and exchanges, and (2) 30 percent of the excess of the net capital gain for the year over the amount of gain taken into account under (1).

#### ***Revenue effect***

This provision will reduce budget receipts by \$53 million in fiscal year 1979, \$125 million in fiscal year 1980, and \$170 million in fiscal year 1983.

#### **4. Exclusion of Gain on Sale of Residence (sec. 404 of the Act and sec. 121 of the Code)**

##### ***Prior law***

###### ***In general***

Generally, the entire amount of gain or loss realized on the sale or exchange of property is recognized. However, under a "rollover" provision of the Code, gain is not recognized on the sale or exchange of a taxpayer's principal residence if a new principal residence, at least equal in cost to the adjusted sales price of the old residence, is purchased and used by the taxpayer as his or her principal residence within a period beginning 18 months before, and ending 18 months after, the date of the sale of the old residence. The basis of the new residence then is reduced by the amount of the gain not recognized on the sale of the old residence. When the purchase price of the new residence is less than the adjusted sales price of the old residence, gain is recognized only to the extent that the adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence.

If, however, an individual realizes gain on the sale or exchange of a residence and fails to satisfy the rollover requirements, then the gain generally is taxable pursuant to the usual rules of the Code.

###### ***Individuals age 65 and over***

Under prior law (sec. 121), an individual who attained the age of 65 could elect to exclude from gross income, on a one-time basis, the entire gain realized on the sale of his or her principal residence, if the adjusted sales price was \$35,000 or less. If the adjusted sales price exceeded \$35,000, the amount excludible was that portion of the gain which was determined by multiplying the total gain by a fraction, the numerator of which was \$35,000, and the denominator of which was the adjusted sales price of the residence. The exclusion was not available unless the property was owned and used by the taxpayer as his or her principal residence for a period aggregating 5 years or more during the 8-year period preceding the sale. Due to this actual use and occupancy requirement, the holding period of a condemned or involuntarily converted residence was not added to that of a replacement residence for purposes of having gain on the sale of the latter property qualify for the exclusion.

A taxpayer who attained the age of 65 could utilize the special exclusion and then use the generally available rollover provision (sec. 1034) with respect to the balance of any gain.

##### ***Reasons for change***

The Congress believed that the taxes imposed upon an individual with respect to gain that he or she realizes on the sale or exchange of his or her principal residence, in many instances, may be unduly high, especially in view of recent inflation levels and the increasing cost of housing. The Congress believed that, in most situations, the nonrecog-

dition provisions of present law operate adequately to allow individuals to move from one residence to another without recognition of gain or payment of tax. However, where an individual has owned his or her principal residence for a number of years and sells it either to purchase a smaller, less expensive dwelling, or to move into rental quarters, any tax due on the gain realized may be too high. While the provisions of prior law relating to the exclusion of gain by taxpayers who attained the age of 65 may ameliorate this situation somewhat, the Congress believed that the prior dollar limits and age restriction were unrealistic in view of increasing housing costs and decreasing retirement ages. In addition, the Congress believed that the holding period of a principal residence which is involuntarily converted should be tacked to that of a replacement residence for purposes of meeting the use and occupancy requirements needed to qualify for the exclusion upon a sale of the replacement residence.

### ***Explanation of provision***

The Act amends the provision relating to the exclusion of gain on the sale of a principal residence by an individual who has attained the age of 65. The amended provision provides that an individual who has attained the age of 55 may exclude from gross income, on a one-time elective basis, up to \$100,000 (\$50,000 in the case of married individuals who file separate returns) of any gain realized on the sale or exchange of his or her principal residence (including both condominiums and shares of stock by a tenant-shareholder in a cooperative housing cooperation). In the case of a principal residence held jointly, or as community property, by a husband and wife, only one of the spouses must have attained the age of 55. This rule with respect to jointly held residences applies only to married taxpayers.

The exclusion applies only in the case of gain from the sale of a principal residence which the individual has owned and occupied as his or her principal residence for a period aggregating 3 out of 5 years immediately preceding the sale. This ownership and occupancy rule may be satisfied only by the taxpayer, or by the taxpayer's spouse in the case of married individuals. However, the Act provides two exceptions to the generally applicable ownership and occupancy rule. The first exception is a limited transition rule which provides that an individual who satisfies the age, ownership and use requirements of the provisions of prior law relating to sales by taxpayers who attained the age of 65 (5 years or more out of the 8-year period which preceded the sale) will have until July 26, 1981, to qualify for the exclusion either under the new ownership and occupancy test or that of the prior law. The second exception provides that the use and holding period of a condemned or involuntarily converted residence may be tacked to that of a replacement residence for purposes of having gain on the sale of the latter property qualify for the exclusion. In other cases, the holding period for an old residence will not be taken into account even if gain on that residence's sale had been rolled over into the new principal residence which is being sold.

For purposes of the exclusion contained in the Act, the definition of a taxpayer's principal residence is that presently utilized in section 1034 (relating to rollovers). Therefore, whether property qualifies as an individual's principal residence, or what portion of a property quali-

fies, will depend upon the facts and circumstances in each case. Similarly, the facts and circumstances test is to apply to determine which residence is a taxpayer's principal residence where he or she has owned and occupied more than one residence during the 5-year period preceding the sale in question.

Of course, if an individual realizes gain in excess of the amount excluded under the Act, the taxpayer's remaining gain is to be subject to the regular income tax in the same manner as other capital gains. Therefore, only 40 percent of the individual's long-term capital gain in excess of the amount excluded under the Act would be includible in the taxpayer's taxable income.

As under prior law, both the exclusion and the nonrecognition provisions of sections 1033 and 1034 may be used with respect to gain realized on the sale of a principal residence. Thus, the amount that would have to be reinvested in a new principal residence is reduced by the amount excluded from income, and the amount of any gain excluded on the prior sale will not reduce his or her basis for the new residence.

A taxpayer who previously elected to use the one-time \$35,000 exclusion ratio provision available to individuals 65 or over also may qualify to use the new election without reduction of the excludable amount.

As under prior law, each taxpayer is allowed to elect the exclusion only once in his or her lifetime. Thus, the rules under prior law will continue to apply to determine when an individual is ineligible to make the election in the case of single taxpayers becoming married and married taxpayers becoming divorced. Under these rules, if spouses make an election during marriage, and subsequently become divorced, no further elections are available to either of them or to their spouses should they marry. Also, if a single taxpayer makes the election and subsequently marries, no further election is allowed to the married individuals. If, however, each of two parties made an election independently prior to becoming married, there is to be no recapture of the tax which is attributable to the gain excluded with respect to the sale of either of the residences.

(Under section 421 of the Act, no amount of any gain realized on the sale of an individual's principal residence, whether or not excludable under the Act, is a tax preference subject to the minimum tax.)

### ***Effective date***

This provision is effective for sales and exchanges after July 26, 1978.

### ***Revenue effect***

This provision will reduce budget receipts by \$165 million in fiscal year 1979, \$415 million in fiscal year 1980, and \$552 million in fiscal year 1983.

## 5. Rollover of Gain on Sale of Residence (sec. 405 of the Act and sec. 1034 of the Code)

### *Prior law*

Prior to the Tax Reduction Act of 1975, gain realized from the sale of property used by the taxpayer as his or her principal residence ("old residence") generally was not recognized where the taxpayer purchased and used property as his or her principal residence ("new residence"),<sup>1</sup> within a period beginning 12 months before, and ending 12 months after, the sale. In determining which residence was a taxpayer's new residence, where he or she purchased more than one property which was used as a principal residence during the 12 months after the sale of the old residence, only the last residence so used by the taxpayer constituted a "new residence."

This nonrecognition treatment was available, however, only once during any 12-month period. Thus, where the nonrecognition treatment applied to the sale of a taxpayer's residence, it would not apply again for a period ending one year from the date of the sale of the old residence.

The 1975 Act extended the replacement time period for the purchase of a new residence to the period beginning 18 months before the sale of the old residence and ending 18 months after such sale. The 1975 Act also applied the 18-month period in determining which residence was the replacement residence where more than one residence was used by the taxpayer as a principal residence after the sale of the old residence, i.e., the last principal residence so used during the 18-month period was the "new residence." Under the 1975 Act, nonrecognition treatment was available only once during any 18-month period.<sup>2</sup>

### *Reasons for change*

The generally applicable provisions of present law may result in hardship for certain individuals who have had to relocate more than

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<sup>1</sup> Under section 1034, gain is recognized only to the extent that the adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence.

<sup>2</sup> The operation of the generally applicable provisions of prior law can be illustrated by the following example:

A taxpayer sells an old residence on January 15, 1976, and purchases a new residence on February 15, 1976. In March 1977, the taxpayer's employer permanently transfers him or her to a new principal place of work approximately 1,000 miles from the taxpayer's former principal place of work and former principal residence. On April 15, 1977, the taxpayer sells his or her new residence purchased on February 15, 1976. On May 15, 1977, the taxpayer purchases a second new residence at his new principal place of work, and sales price of the residence sold. Under prior law, the taxpayer's new residence, for purposes of the rollover of gain, is the principal residence purchased on May 15, 1977. Thus, under prior law, the taxpayer would recognize no gain on the January 15, 1976 sale, but would recognize gain (long term capital gain) on the April 15, 1977 sale, because of the operation of the 18-month limitation provision.



once during any 18-month period. The hardship resulted, in part, from the impact of inflation on the value of homes, and, in part, from the unavailability of the rollover provision where more than one principal residence was sold within the 18-month statutory period. In such situations large gains could be realized even though a house was held by the taxpayer for less than 18 months. The Congress believed that the 18-month limitation was too restrictive in light of the fact that employees and self-employed individuals frequently may be required to change employment locations.

### ***Explanation of provision***

The Act generally provides for the rollover of gain realized on the sale of more than one principal residence where an individual relocates for employment purposes within a period beginning 18 months from the time that his or her first principal residence is sold. Taxpayers generally will be allowed the benefits of this multiple rollover provision where there was a reasonable expectation at the time of the relocation that the taxpayer would be employed at the new location for a substantial period of time.

Thus, where the taxpayer is entitled to deduct moving expenses with respect to a relocation falling within the 18-month period, the 18-month limitation of present law generally would not apply. In such a situation, the multiple rollover provision would be available so as to allow the nonrecognition of gain on the sale of a principal residence even though there had been nonrecognition of gain on the sale of another principal residence within the preceding 18 months. However, in order to qualify for such treatment, a sale must be in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work, and the taxpayer must satisfy both the geographic and length of employment requirements for deductibility of moving expenses (secs. 217(c) and 217(d)).<sup>3</sup> In applying the moving expenses test to a residence sold within the 18-month limitation period, the residence sold is treated as the "former residence."

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<sup>3</sup> The operation of the provision is illustrated by the following example:

A taxpayer sells his old residence on January 15, 1979, and purchases a new residence on February 15, 1979. In July 1979, taxpayer's employer permanently transfers him to a new principal place of work 1,000 miles from the taxpayer's former principal place of work and former principal residence. On August 15, 1979, taxpayer sells his new residence purchased February 15, 1979. On September 1, 1979, taxpayer purchases and uses a second new residence at his new principal place of work. Since the August 15, 1979, sale occurred within 18 months of the January 15, 1979 sale, the 18-month limitation provision of section 1034(d) would generally apply. However, since the August 15, 1979 sale was in connection with the commencement of work by the taxpayer as an employee in a new principal place of work and since the taxpayer satisfies the conditions of section 217(c), the 18-month limitation would not apply to the August 15 sale, and the taxpayer would be eligible for nonrecognition treatment on that sale. In addition, the residence sold August 15 is treated as the last new residence used within the "18-month" period following the January 15, 1979, sale of the taxpayer's old residence, and as an old residence for purposes of the running of the next 18-month limitation period.

If, however, the taxpayer's transfer to a new principal place of work was a temporary transfer which he reasonably could have expected to last only 26 weeks, the provisions of the Act would be inapplicable, the gain realized on the August 15, 1979, sale would be recognized and the residence purchased on September 1, 1979, would be the replacement residence.

To qualify for the multiple rollover provision it is not necessary for an individual to remain with the same employer, nor actually to satisfy the time test of section 217. Instead, the taxpayer only has to have a reasonable expectation at the time of the move, that he or she would satisfy the time condition. Thus, the provision would not be available if the taxpayer reasonably could have been expected to know that the time test of section 217 could not be satisfied.

In addition, a sale which meets the requirements of the Act will be treated as terminating the 18-month period and starting another 18-month period. Thus, the principal residence receiving rollover treatment under the Act will constitute a new residence with respect to the prior rollover sale and an old residence for purposes of its sale.

Where the multiple rollover provision applies, the basis of each succeeding principal residence is to be reduced by the amount of gain not recognized on the sale of the prior residence.

### ***Effective date***

This provision is effective for sales and exchanges of principal residences after July 26, 1978.

### ***Revenue effect***

This provision will reduce budget receipts by \$3 million in fiscal year 1979, \$4 million in fiscal year 1980, and \$4 million in fiscal year 1983.

## **B. MINIMUM TAX PROVISIONS**

### **1. Alternative Minimum Tax on Individuals (sec. 421 of the Act and secs. 55-58 of the Code)**

#### ***Prior law***

Prior law (sec. 56 of the Code) provided a minimum tax on certain tax preferences of individuals and corporations. The minimum tax for individuals amounts to 15 percent of the sum of an individual's (or estate's or trust's) tax preferences in excess of the greater of one-half of regular income taxes paid or, \$10,000.

The tax preference items included in this base of the minimum tax for individuals were:

(1) Accelerated depreciation on real property in excess of straight-line depreciation;

(2) Accelerated depreciation on personal property subject to a lease in excess of straight-line depreciation;

(3) Amortization of certified pollution control facilities (the excess of 60-month amortization (sec. 169) over depreciation otherwise allowable (sec. 167));

(4) Amortization of railroad rolling stock (the excess of 60-month amortization (sec. 184) over depreciation otherwise allowable (sec. 167));

(5) Qualified stock options (the excess of the fair market value at the time of exercise over the option price);

(6) Percentage depletion in excess of the adjusted basis of the property;

(7) The deduction for long-term capital gains;<sup>1</sup>

(8) Amortization of child care facilities (the excess of 60-month amortization (sec. 188) over depreciation otherwise allowable (sec. 167));

(9) Itemized deductions (other than medical and casualty loss deductions) in excess of 60 percent of adjusted gross income;<sup>1</sup> and

(10) Intangible drilling costs on oil and gas wells in excess of the amount amortizable with respect to those costs and, for 1977, in excess of net income from oil and gas production.

These items of tax preference (including the net capital gain preference) also reduce, on a dollar-for-dollar basis, the amount of personal service income eligible for the 50-percent maximum tax.

#### ***Reasons for change***

The Congress believes that, in the case of capital gains, the present minimum tax has adversely affected capital formation and that the purpose for which the present minimum tax was enacted can be accom-

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<sup>1</sup> Effective for taxable years beginning after December 31, 1978, the Act eliminates these items as tax preferences under the add-on minimum tax, but characterizes them as such for purposes of the alternative minimum tax.

plished better, in the case of capital gains, by the implementation of an alternative minimum tax on capital gains which would be payable only to the extent it exceeds an individual's regular tax liability. By eliminating capital gains as an item of tax preference under the present minimum tax, and by enacting an alternative minimum tax applicable to capital gains and adjusted itemized deductions, the Congress anticipates that capital formation will be facilitated, and every individual will pay at least a reasonable minimum amount of tax with respect to large capital gains.

While the Congress believes that it is appropriate to substitute an alternative minimum tax for the present minimum tax in the case of capital gains and adjusted itemized deductions, it also believes that the present minimum tax should be retained in the case of the other items of tax preference.

For these reasons, the Congress agreed to an alternative minimum tax, which is to be paid only to the extent that the tax exceeds a taxpayer's regular tax liability including a revised add-on minimum tax. The alternative minimum tax rates rise to a maximum of 25 percent for those persons with incomes (including certain preferences) exceeding \$100,000. Thus, taxpayers paying high regular taxes (i.e., approaching, or in excess of, 25 percent of very large incomes) generally will not be subject to any alternative minimum tax, and they thus will have no disincentive, attributable to the minimum tax, for making capital gain investments. However, the provision will insure that those high income individuals currently paying low regular taxes and realizing large capital gains will pay substantially more tax in the future.

### ***Explanation of provision***

#### *General*

The Act generally retains the prior law minimum tax with respect to all preference items except the deducted amount of net capital gain and adjusted itemized deductions. The Act also establishes an alternative minimum tax which is payable by noncorporate taxpayers to the extent that it exceeds the regular tax paid as increased by the revised add-on minimum tax. Thus, although the tax is in effect a true alternative tax, in the sense that it is paid only when it exceeds regular tax (including any add-on minimum tax liability), technically the taxpayer's regular and add-on minimum taxes continue to be imposed and the amount of alternative minimum tax is the excess of the amount computed under the alternative minimum tax rate table over the amount of the regular and add-on minimum taxes.

#### *Computation*

The alternative minimum tax is based on the sum of a noncorporate taxpayer's gross income reduced by deductions allowed for the year (including deductions in excess of gross income, if any), and by amounts included in income under section 667 (relating to accumulation distributions from trusts), and increased by the amount of the taxpayer's adjusted itemized deductions, and capital gains deduction.

This amount then is subject to the following alternative minimum tax rates:

<i>Alternative minimum taxable income</i>	<i>Percent</i>
\$0 to \$20,000-----	0
\$20,000 to \$60,000-----	10
\$60,000 to \$100,000-----	20
Over \$100,000-----	25

The resulting amount then is compared to regular tax liability, as increased by the add-on minimum tax. For this purpose, the computation of regular tax does not include the taxes imposed by sections 72(m) (5) (B) (relating to annuities), 402(e) (relating to certain distributions from qualified pension plans), 408(f) (relating to individual retirement accounts), or 667(b) (relating to accumulation distributions), and the tax must be reduced by the sum of all allowable credits (including the foreign tax credit) other than those for withheld tax (sec. 31), refunds of certain gasoline, special fuels, and lubricating oil taxes (sec. 39), and the earned income credit (sec. 43). If alternative minimum tax liability exceeds regular income tax liability, as increased by the add-on minimum tax, the greater amount is payable.<sup>2</sup>

#### *Treatment of credits*

The foreign tax credit and refundable credits are the only tax credits which are allowed against any alternative minimum tax liability. Thus, taxpayers paying the alternative minimum tax do not obtain the benefit of nonrefundable credits, other than the foreign tax credit, to the extent of the minimum tax. However, in the case of the investment tax credit, the jobs credit, and the WIN credit, the Act provides that any credit carryover or carryback from a year in which the taxpayer is liable for some amount of alternative minimum tax, is not to be reduced to the extent of the taxpayer's alternative minimum tax liability. For example, assume a taxpayer has a regular tax liability before credits of \$10,000, investment tax credits of \$5,000 and alternative minimum tax before regular tax offset of \$8,000 (consisting of regular tax of \$5,000 and alternative minimum tax of \$3,000). In this case, the taxpayer has used up all \$5,000 of investment tax credits against regular tax but has received a benefit only from \$2,000 of credits. Thus, the remaining \$3,000 of credit for which no tax reduction was obtained is to be available as an additional carryover to the next year to which

<sup>2</sup> No special rule is provided similar to the rule under section 56(b) relating to the deferral of minimum tax liability in the case of net operating losses. In computing the net operating loss for any taxable year, the capital gains deduction under section 1202 is not taken into account and nonbusiness deductions are generally limited to the amount of nonbusiness income (sec. 172(c) and (d)). In addition, in determining the amount of a net operating loss carryover to the current taxable year, the reduction for prior years' taxable income is computed without regard to the prior years' section 1202 deduction (sec. 172(b) (2) (A)). Therefore, generally these preferences cannot create a net operating loss.

However, a taxpayer having adjusted itemized deductions in the current taxable year may receive the benefit of having certain nonpreferential deductions (including deductions under section 172) reduce the alternative minimum taxable income in the current year and still be available as a net operating loss carryover to succeeding years. It is intended that any deduction, to the extent it may be carried to another year, is not to reduce alternative minimum taxable income for the current year.

the credit would be otherwise carried over under the usual rules if the credit did not otherwise expire.<sup>3</sup>

### *Preferences for the alternative minimum tax*

For purposes of the alternative minimum tax there are two preferences. The capital gains preference is the amount of a taxpayer's section 1202 capital gains deduction, but does not include any deduction which is attributable to the gain from sale of a taxpayer's principal residence.

The other alternative minimum tax preference is adjusted itemized deductions. This preference excludes medical and casualty deductions, State and local tax deductions and, in the case of income in respect of a decedent, amounts deducted (under sec. 691(c)) for estate taxes. (However, income in respect of a decedent which is capital gain continues to be a tax preference.) The remaining itemized deductions are preferences only to the extent they exceed 60 percent of adjusted gross income minus the medical and casualty deductions, State and local tax deductions, and the deduction for estate taxes attributable to the inclusion of income in respect of a decedent in a decedent's gross estate. Thus, for example, a taxpayer with AGI of \$50,000 and total itemized deductions of \$45,000 (including \$10,000 State and local taxes and no medical or casualty expenses) would have \$35,000 of deductions subject to the preference computation. The amount of the preference would equal the excess of these deductions over 60 percent of \$40,000 (\$50,000 AGI less \$10,000 State and local taxes), or \$24,000. Thus, the preference is \$35,000 minus \$24,000, or \$11,000.

### *Foreign tax credit*

The foreign tax credit is to be allowed separately against the alternative minimum tax, and, in general, the regular foreign tax credit rules apply. However, in determining the allowable credit, the foreign tax credit limitation is to be computed separately on the basis of alternative minimum taxable income. In addition, a number of adjustments are made to the credit rules to take into account the interactions between the alternative minimum tax and the regular tax.

Although the alternative minimum tax is structured as an additional tax equal to the excess of the gross alternative minimum tax over regular tax liability, it is conceptually an alternative to the regular tax. Accordingly, the rules applicable in computing the foreign tax credit against the alternative minimum tax are designed to reach

<sup>3</sup> Similarly, assume that the 90 percent investment tax credit limitation is in effect, and that a taxpayer has regular tax liability before credits of \$100,000, investment tax credits of \$120,000, and a potential alternative minimum tax (before regular tax offset) of \$60,000. The taxpayer will pay a tax of \$60,000 (consisting of regular tax of \$10,000, and alternative minimum tax of \$50,000). Here the taxpayer has used \$90,000 of the \$120,000 of investment tax credits against regular tax, but has received a benefit only from \$40,000 of those credits. Thus, the remaining \$50,000 of credits, for which no tax reduction was obtained, is available as an additional carryover (together with any other credits available to be carried over) to the next year to which the credit would be carried under the usual rules if the credit carryover did not expire.

Where the amount of credits from which no benefit is obtained involves more than one tax credit, the additional credit allowed as a carryover is first to be allocated to the credit which is taken last under the normal Code rules.

the same results that would obtain if the tax were structured as an alternative to the regular tax (under which the taxpayer's pre-credit liability for the year would be the greater of his pre-credit regular tax or his pre-credit "gross" alternative minimum tax (the alternative minimum tax before the regular tax offset)). However, since the credit limitations applicable to the regular tax and to the alternative minimum tax are computed with reference to different taxable income bases, it would be possible under certain circumstances for a taxpayer's pre-credit gross alternative minimum tax to exceed his pre-credit regular tax while his after-credit alternative minimum tax is less than his after-credit regular tax. Therefore, in order to prevent the alternative minimum tax from in effect reducing his U.S. taxes actually paid for the year, the taxpayer is required to pay an amount equal to the greater of the after-credit regular tax or the after-credit alternative minimum tax. This is accomplished by limiting the alternative minimum tax foreign tax credit to the net alternative minimum tax (the excess of the gross alternative minimum tax over the after-credit regular tax).

As in the case of the regular tax, the credit taken against the alternative minimum tax cannot exceed the portion of that tax attributable to foreign source income. In keeping with the underlying concept of the alternative minimum tax as an alternative to the regular tax, the foreign tax credit limitation is generally based on the gross alternative minimum tax. The limitation is computed with reference to alternative minimum taxable income by modifying the limiting fraction applicable in determining the regular tax credit limitation to include the preference items (the capital gains deduction and adjusted itemized deductions) which are added back to taxable income in computing the income subject to the alternative minimum tax. Thus, the credit is limited to the same proportion of the gross alternative tax which the taxpayer's alternative minimum taxable income from sources without the United States (but not in excess of the taxpayer's alternative minimum taxable income) bears to his entire alternative minimum taxable income. the same proportion of the gross alternative tax which the taxpayer's alternative minimum taxable income from sources without the United States (but not in excess of the taxpayer's alternative minimum taxable income) bears to his entire alternative minimum taxable income. (While the limitation, since it is computed with reference to the gross alternative minimum tax, may exceed the taxpayer's net alternative minimum tax (i.e., the tax after the regular tax offset), the credit taken can not exceed that amount.)

The foreign tax credit allowed against the regular tax reduces that tax and may, to the same extent, increase the taxpayer's net alternative minimum tax liability. This in effect would cause the loss of the tax benefit of the foreign tax credit against the regular tax since credits are treated as used under existing law. They are not available as carryovers or carrybacks (or for use against the alternative minimum tax). To preserve the value of these credits, an adjustment is made under which the taxpayer is deemed to have paid additional creditable foreign taxes in an amount equal to the amount by which the tax credit taken against the regular tax reduces the regular tax offset

and thus increases the taxpayer's pre-credit alternative minimum tax (that is, the lesser of (i) the foreign tax credit taken against the regular tax or (ii) the pre-credit net alternative minimum tax.) In determining the amount of excess credits available for carryover or carry-back after taking the credit against the alternative minimum tax, the taxpayer is treated as having been allowed a foreign tax credit equal to the difference between (i) the greater of the gross regular tax and the gross alternative minimum tax (conceptually, the initial measure of tax liability) and (ii) the combined total of the regular and alternative minimum taxes actually paid after the foreign tax credit.

These rules may be illustrated by the following example of a taxpayer with \$200,000 of net capital gains, half from U.S. sources and half from foreign sources, and an ordinary loss allocable to U.S. sources of \$30,000. After the 60 percent capital gains deduction his taxable income is \$50,000, and his regular U.S. tax before the foreign tax credit is \$15,000. He pays creditable foreign income taxes of \$20,000, his foreign tax credit limitation is \$12,000 (\$15,000 times \$40,000/\$50,000), and, therefore, his regular U.S. tax after the foreign tax credit is \$3,000. The taxpayer's gross alternative minimum tax (i.e., the tax before the regular tax offset) is \$29,500 on alternative taxable income of \$170,000. After the regular tax offset of \$3,000, the alternative minimum tax (before foreign tax credits) is \$26,500.

The taxpayer's alternative minimum tax foreign tax credit limitation is \$17,353 (\$29,500 times \$100,000/\$170,000). The taxpayer used \$12,000 of his \$20,000 of creditable foreign income taxes against his regular tax liability, leaving \$8,000, but he is deemed to have paid an additional \$12,000 (the lesser of his \$26,500 alternative minimum tax and the \$12,000 in foreign taxes used against the regular tax) in foreign taxes available to credit against the alternative minimum tax or to carry to other years. His alternative minimum tax net of the foreign tax credit is \$9,147 (\$26,500 less \$17,353). The taxpayer will therefore pay a net basic income tax of \$3,000 and a net alternative minimum tax of \$9,147 for a total of \$12,147. The excess credits that may be carried to another year would be \$2,647—the amount by which the sum of the \$20,000 foreign taxes actually paid during the year and the \$12,000 additional foreign taxes deemed paid under this section exceeds the sum of the regular tax foreign tax credit limitation of \$12,000 and the alternative minimum tax foreign tax credit limitation (to the extent it does not exceed the alternative minimum tax) of \$17,353. (In this example, the amount of foreign taxes available to be carried to another year is equal to the difference between the \$20,000 foreign taxes paid (without regard to the additional foreign taxes deemed paid under this section) and the \$17,353 foreign tax credit taken against the alternative minimum tax. However, this would not be the case where the taxpayer's pre-credit regular tax is greater than his pre-credit gross alternative minimum tax.)

Certain additional modifications are necessary if the taxpayer is also liable for the add-on minimum tax imposed under section 56. The foreign tax credit is not allowed against the add-on minimum tax, and, therefore, the multiplicand of the alternative minimum tax foreign



tax credit limitation formula is reduced by the amount of the add-on minimum tax.<sup>4</sup>

### *Special rules*

The provision also includes special rules for the application of the alternative minimum tax in the case of estates and trusts. The rate schedule applicable to estates and trusts is the same as the rates applicable to married individuals filing a separate return. Also, accumulation distributions from a trust included in income under section 667 are not to be included in the alternative minimum tax base and the partial tax under section 667(b) is not treated as tax paid for purposes of determining the regular tax. Generally, tax preferences of an estate or trust are to be apportioned between it and its beneficiaries on the basis of estate or trust income allocable to each.

Finally, in the case of accumulation distributions from a trust, the amount of taxes deemed imposed on the trust is not to be increased by any alternative minimum tax in excess of the trust's regular tax liability. Thus, no credit is available to any beneficiary of an accumulation distribution for any minimum tax paid by the trust with respect to that distribution; however, under the normal trust rules, no amount received by that beneficiary is treated as an item of tax preference to the beneficiary. (Other special rules, under section 701(q) of the Act, apply in the case of foreign taxes and accumulation distributions.)

Personal holding companies are treated the same as other corporations and will be subject to the add-on minimum tax but not to the alternative minimum tax. However, the preference for accelerated depreciation on leased personal property (sec. 57(a)(3)) and for intangible drilling costs (sec. 57(a)(11)) will apply to these corporations.

### *Effective date*

In general, the provision is effective for taxable years beginning after 1978, except that the change in the capital gains preference to exclude gain on the sale or exchange of a principal residence is effective for sales or exchanges after July 26, 1978. In addition, the provision is not to be treated as a change of the rate of tax (under sec. 21 of the Code). Thus, fiscal year taxpayers are to first be subject to the alternative minimum tax for their taxable year beginning in 1979.

<sup>4</sup> This rule may be illustrated by modifying the example in the text so that the \$30,000 ordinary loss is composed in part of a deduction for accelerated depreciation which exceeds straight-line depreciation by \$20,000, on which the taxpayer pays add-on minimum tax of \$1,500. His pre-credit alternative minimum tax is \$25,000, the difference between his gross alternative minimum tax of \$29,500 and his regular tax of \$4,500 (\$3,000 plus \$1,500). The taxpayer's alternative minimum tax foreign tax credit limitation is \$16,471 ((\$25,000 plus \$3,000) times \$100,000/\$170,000), and his alternative minimum tax after the foreign tax credit is \$8,529 (\$25,000 less \$16,471). The taxpayer will therefore pay a net basic income tax of \$3,000, and add-on minimum tax of \$1,500, and an alternative minimum tax of \$8,529 for a total of \$13,029. The excess credits which may be carried to another year are \$3,529—the excess of the \$32,000 foreign taxes paid or deemed paid (\$20,000 plus \$12,000) over the \$28,471 foreign tax credits taken against the regular tax (\$12,000) and against the alternative minimum tax (\$16,471).

***Revenue effect***

It is estimated that the combined net effect of these changes will reduce budget receipts by \$535 million in fiscal year 1980, \$588 million in fiscal year 1981, and \$711 million in fiscal year 1983. (See Table I-2, for the separate fiscal year revenue effects of the removal of certain preference items from the present law minimum tax and the new alternative minimum tax.)

## **2. Treatment of Intangible Drilling Costs for Purposes of the Minimum Tax (sec. 422 of the Act and sec. 57 of the Code)**

### ***Present law***

Under present law, the operator of an oil or gas well may elect to deduct intangible drilling and development costs as an expense rather than capitalize the costs and recover them through depletion and depreciation deductions. Generally, intangible drilling and development costs are defined as those expenditures made by the owner of an operating interest for wages, fuel, repairs, hauling, supplies, etc., incurred in preparing a drill site, drilling and cleaning a well, and constructing assets which are necessary in drilling the well and preparing it for production (such as derricks, pipelines, and tanks). Under the Tax Reform Act of 1976, the deduction for intangible drilling costs for a taxable year in excess of the deduction which would have been allowed with respect to those costs for that year through either 10-year amortization or cost depletion was treated as a tax preference item for purposes of the minimum tax for individuals.

In the Tax Reduction and Simplification Act of 1977, the Congress provided that for taxable years beginning only in 1977 intangible drilling and development costs (over the amount which would have been allowable under either 10-year amortization or cost depletion) in excess of oil and gas production income would constitute a tax preference item. However, this rule would not apply for future years unless there was further Congressional action.

### ***Reasons for change***

The classification of certain intangible drilling expenses as a tax preference item under the minimum tax in order to curtail the use of oil and gas tax shelters resulted in a disincentive for increased exploration by individuals in the business of exploring for, and developing, oil and gas properties. This disincentive has had a significant impact, particularly on independent producers, who do most of the exploratory drilling for new oil in the United States.

The Congress believed that by applying the preference only where intangible drilling costs exceed oil and gas production income the preference will not constitute a major disincentive to those individuals in the oil and gas business, but will continue to limit the ability of outside investors to reduce the income tax otherwise payable on their dividend or salary income through the use of the intangible drilling cost deduction.

### ***Explanation of provision***

The Act extends for all future years the minimum tax provision for intangible drilling costs of individuals which was enacted by the Tax Reduction and Simplification Act of 1977. As a result, intangible drilling cost deductions for oil or gas wells are included in the minimum tax

base of individuals only to the extent that intangible drilling and development costs incurred in a taxable year, over the amount of those costs amortizable on the basis of a 10-year life or under cost depletion, exceed the taxpayer's income from oil and gas properties. Income from oil and gas properties is to be determined first with reference to the rules for determining gross income from oil and gas properties for purposes of percentage depletion (sec. 613(a) of the Code) but without regard to the limitations under sec. 613A. Net income from oil and gas properties is gross income from oil and gas properties reduced by the amount of deductions (other than intangible drilling costs subject to the preference) properly attributable to that gross income. Under the provision, deductions attributable to properties with no gross income are not intended to be taken into account for purposes of computing net income from oil and gas properties.

***Effective date***

These provisions are effective upon enactment and apply to taxable years beginning after December 31, 1977.

***Revenue effect***

This provision will reduce budget receipts by \$51 million in fiscal year 1979, \$61 million in fiscal year 1980, and \$97 million in fiscal year 1983. (The revenue effects of this provision are not shown in the revenue tables and have not been included in the total figures on budget effects of this Act because they have been attributed to H.R. 5263, the Energy Tax Act of 1978.)

### **3. Amendment to Definition of Foreign Source Capital Gain Tax Preference (sec. 423 of the Act and sec. 58 of the Code)**

#### ***Prior law***

In the case of a corporation, capital gains are generally treated as items of tax preference to the extent that they are subject to tax at the reduced rate of tax for net capital gains. (The preference item is an amount equal to the product of the net capital gain multiplied by a fraction the numerator of which is the excess of the highest corporate tax rate over the alternative tax rate for capital gains, and the denominator of which is the highest corporate tax rate; after the amendments made by the 1978 Act, the rate differential fraction is 18/46ths.) However, as an exception to this general rule, capital gains which are attributable to sources within a foreign country or possession are not treated as preference items if capital gains do not receive preferential treatment under the laws of the foreign country or possession.

#### ***Reasons for change***

Certain corporate reorganizations receive nonrecognition treatment under the tax laws of the foreign country in which the corporations conduct their businesses but are treated in part or in full as taxable transactions for U.S. tax purposes. Congress believed that the minimum tax should not be imposed on gains received in such reorganizations occurring in foreign countries which do not ordinarily provide preferential treatment for capital gains merely because the gain is given nonrecognition treatment for foreign tax purposes but not for U.S. tax purposes.

#### ***Explanation of provision***

The Act modifies the exception from the minimum tax for foreign source capital gains not receiving preferential treatment to include gains on the receipt of property (other than money) in exchange for stock in a corporation engaged in the active conduct of a trade or business in a foreign country or possession if the following criteria are met. First, the transaction is an exchange described in section 332, 351, 354, 355, 356, or 361. Second, the transaction is made in the foreign country or possession in which the corporation's business is primarily carried on. Third, the transaction is provided nonrecognition treatment under the tax law of that country or possession. Finally, if the gain had been taxable under the laws of the foreign country or possession, it would not have been afforded preferential treatment and would have been subject to tax at a rate of at least 28 percent (30 percent if the exchange occurs before 1979).

For purposes of computing the minimum tax which may be payable on any subsequent transaction involving property received in an exchange of stock qualifying under this provision, the property received is to be treated as having the same basis in the taxpayer's hands im-

mediately after the exchange that the exchanged stock had immediately before the exchange.

***Effective date***

This provision was effective on November 6, 1978.

***Revenue effect***

This provision will reduce budget receipts by \$5 million in fiscal year 1979 and by less than \$1 million a year thereafter.

## **C. MAXIMUM TAX REVISIONS**

### **1. Capital Gains Tax Preference Offset of Earned Income Under the Maximum Tax (sec. 441 of the Act and sec. 1348 of the Code)**

#### ***Prior law***

Under present law, the maximum marginal tax rate applicable to taxable income from personal services generally is 50 percent. However, the amount of personal service income eligible for the maximum tax is reduced dollar-for-dollar by the amount of an individual's tax preferences for the year. Under prior law, this offset included the amount of an individual's capital gains tax preference.

#### ***Reasons for change***

The provision of prior law which reduced the amount of personal service income eligible for the maximum tax by an individual's capital gains tax preference could act as a serious impediment to productive investment activity by effectively increasing an individual's taxes. For example, in the case of a 70-percent income tax bracket individual who potentially was able to utilize the maximum tax on personal service income, the capital gain tax preference offset could result in increasing the individual's effective tax rate on capital gains by 10 percentage points. To prevent this interaction from discouraging individuals from making needed investments in the economy, the Congress repealed the capital gains tax preference offset of earned income eligible for the maximum tax. With the Act's revision of the minimum tax with respect to capital gains, the purpose for which the capital gains tax preference offset originally was enacted should be preserved.

#### ***Explanation of provision***

The Act removes the capital gains tax preference as an offset of the amount of personal service income eligible for the maximum tax rate. However, other tax preferences continue to reduce maximum tax benefits.

#### ***Effective date***

This provision applies to taxable years beginning after October 31, 1978.

In the case of a taxable year which begins before November 1, 1978, and ends after October 31, 1978, the provision applies only with respect to post-October 31, 1978 transactions. Thus, only the section 1202 deduction based on the lesser of the net capital gain for the taxable year or such gain on transactions occurring before November 1, 1978, will reduce personal service income.

#### ***Revenue effect***

This provision will reduce budget receipts by \$6 million in fiscal year 1979, \$52 million in fiscal year 1980, and \$69 million in fiscal year 1983.

## **2. Maximum Tax on Personal Service Income (sec. 442 of the Act and sec. 1348 of the Code)**

### ***Prior law***

Under present law, the maximum marginal tax rate on taxable income from personal services generally is 50 percent. Income from personal services includes wages, salaries, professional fees, and other compensation for personal services.

Under prior law, if an individual was engaged in an unincorporated trade or business in which both personal services and capital were material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer could be treated as earned income. However, the total amount which could be treated as the taxpayer's earned income from the trade or business could not exceed 30 percent of the taxpayer's share of the net profits from that trade or business. (An analogous, but more flexible, restriction applies in the case of personal service income derived from a corporate trade or business, i.e., earned income does not include compensation which represents a distribution of corporate earnings or profits rather than a reasonable allowance as compensation for personal services actually rendered.)

### ***Reasons for change***

The 30-percent net profits limitation on the amount of compensation from certain unincorporated trades or businesses which may be treated as earned income for purposes of the maximum tax may result in treating unfairly some individuals who conduct their businesses in an unincorporated form. Such individuals may be subject to a greater tax burden than that which is imposed on similarly situated individuals who choose to operate substantially identical businesses in the corporate form. This disparity in tax treatment, in turn, may tend to influence individuals to use a corporate business form for reasons attributable only to potential tax savings. In addition, the 30-percent net profits limitation frequently has raised many definitional questions which have led to controversies and litigation between taxpayers and the Internal Revenue Service.

To eliminate the potential disparity between the tax treatment of personal service compensation from incorporated and unincorporated trades and businesses, the Congress decided to eliminate the 30-percent limit.

### ***Explanation of provision***

The Act removes the 30-percent limitation on the amount of income from a trade or business that can be treated as personal service income where capital is an income-producing factor. Instead, individual taxpayers would receive the benefits of the 50-percent maximum tax on earned income only for income that constitutes a reasonable compensation for the services they actually render whether or not they con-



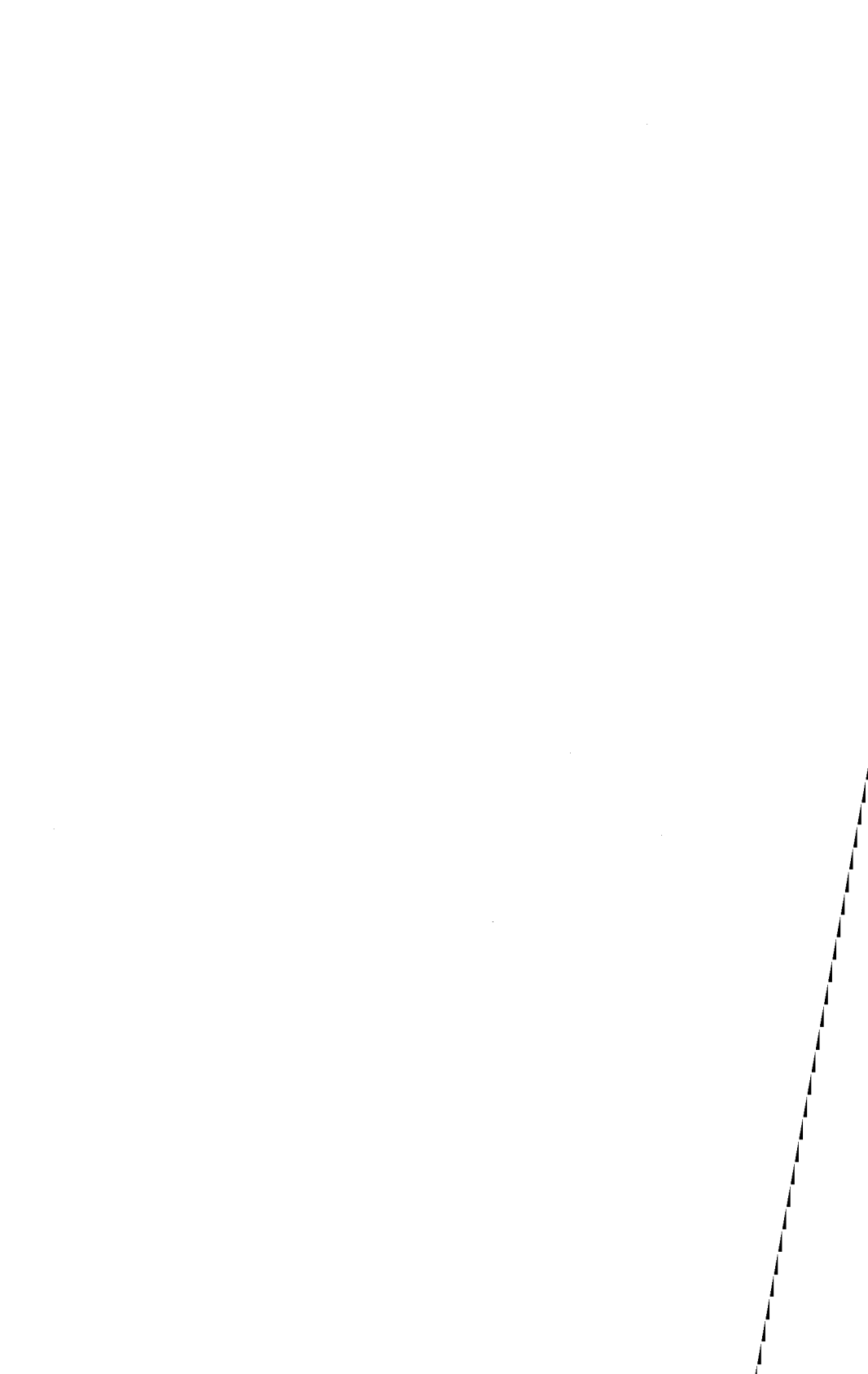
duct their businesses in corporate form. In making this determination, the portion of the net profits of a business which constitutes reasonable compensation for personal services actually rendered would be taken into account as personal service income. However, an individual would not be permitted to convert into personal service income passive income on investments or assets held or used in a trade or business. Whether there has been a conversion of such income into personal service income must be determined by reference to all the facts of each case. For example, a sole proprietor of a business cannot treat dividend and interest income received on investments held by him or by the business as personal service income. If passive income is derived from investments held by a trade or business, expenses of the trade or business must be allocated between such passive income and the trade or business income available for payment as personal service income.

### ***Effective date***

The provision applies with respect to taxable years beginning after December 31, 1978.

### ***Revenue effect***

This provision will reduce budget receipts by \$21 million in fiscal year 1979, \$59 million in fiscal 1980, and \$91 million in fiscal year 1983.



## TITLE V—OTHER TAX PROVISIONS

### A. ADMINISTRATIVE PROVISIONS

#### 1. Reporting Requirements With Respect to Charged Tips (sec. 501 of the Act and secs. 6041 and 6001 of the Code)

##### *Prior law*

Present law (sec. 6053(a) of the Internal Revenue Code) requires an employee to report to his or her employer the tips received by the employee, if exceeding \$20 in a month, by the tenth day of the following month. The Internal Revenue Service has ruled that this reporting requirement applies with respect to both tips paid directly in cash by customers and also tips added to a waiter's check by a charge customer and paid over to the waiter by the employer (Rev. Rul. 75-400, 1975-2 C.B. 464, as modified by Rev. Rul. 76-231, 1976-1 C.B. 378). Under these rulings, the tips required to be so reported by employees are tips received and retained after any tip-splitting, such as by waiters with busboys, or tip-pooling, such as by a waitress with other waitresses.

Section 6051(a) requires employers to report on IRS Forms W-2, as wages subject to income tax withholding and Federal Insurance Contributions Act (social security) withholding, only the tips actually reported to them by their employees pursuant to section 6053(a).<sup>1</sup> However, certain additional informational reporting is required of employers. Section 6041(a) requires every employer of an employee earning \$600 or more yearly to report the total of that employee's earnings to the IRS. In interpreting this additional requirement, the regulations (Treas. Reg. § 1.6041-2(a)(1)) specify that any employee's earnings which are not required to be reported as subject to withholding nonetheless are required to be reported to the IRS by the employer; this additional amount is to be reported separately on the Form W-2 for the employee. Thus in the case of tip income, the IRS has ruled (Rev. Ruls. 75-400 and 76-231, *supra*) that any charge account tips actually paid over by the employer to the employee must be reported to the IRS by the employer (assuming the aggregate \$600 test is met) whether or not the tips were reported to the employer by the employee.<sup>2</sup>

<sup>1</sup> If, because of tip-splitting or tip pooling, the amount of charge tips reported by an employee on his or her Federal income tax return differs from the amount of charge tips reported by the employer for that employee on Form W-2, the rulings permit the employee to attach an explanation of the difference to his or her income tax return.

<sup>2</sup> Under the facts of Rev. Rul. 76-231, *supra*, the employer received customer charge tickets from waiters and reviewed the tickets in order to determine the amounts payable to the employees as tips, thereby becoming aware of the amounts of such tips, whether or not later reported by the waiters to their employer.

Under the cited rulings, the IRS did not apply its new employer reporting requirements with respect to charge tips unreported by employees prior to 1977. The Congress, in section 2111 of the Tax Reform Act of 1976 (P.L. 94-455), provided that the IRS was not to follow Revenue Rulings 75-400 and 76-231 until January 1, 1979, and that, until then, the IRS requirements with regard to reporting charge account tips were to be made in accordance with IRS practice prior to the issuance of those rulings.

### ***Reasons for change***

The Congress concluded that requiring employers to report to the IRS charge account tips paid to employees on the basis of charge receipts (as sought to be imposed by Revenue Rulings 75-400 and 76-231) would place unnecessary recordkeeping and reporting burdens on the employer and would fail to provide the IRS with precise information on the amount of tip income taxable to particular employees. In addition, in some cases, the widespread practices of tip-splitting and tip-pooling would result in an employer's reporting to the IRS an amount of tip income that is greater than the tip income taxable to a particular employee.

### ***Explanation of provision***

The provision amends section 6041 of the Code to make the information return requirements imposed by that section inapplicable to tips with respect to which section 6053(a) of the Code applies.<sup>3</sup> Accordingly, the only employee tips which an employer must report to the IRS are those reported to the employer by employees on statements furnished pursuant to section 6053(a), as required under present law by section 6051(a).<sup>4</sup>

The provision also states that, with respect to the amount of tips paid to a particular employee, the only records of charged tips which an employer will be required to keep under section 6001 of the Code are charge receipts and copies of statements furnished by employees under section 6053(a). Accordingly, an employer will be required to keep charge receipts (which receipts reflect the amount of tips included by the customer in the charged amount), but may not be required to record on such charge receipts, or otherwise keep records of (except copies of sec. 6053(a) statements), the name of any particular employee to whom the charge tip amount is paid over by the employer.

The limitation added by the Act to the recordkeeping requirements which may be imposed on an employer with respect to charged employee tips relates to records of amounts of such tips paid over to a particular employee and does not affect any other recordkeeping requirements which may be applicable to the employer under section 6001 of the Code (*e.g.*, any applicable requirements, for purposes of

<sup>3</sup> This provision was added to the Revenue Act of 1978 by a Senate Finance Committee amendment. The provision was the subject matter of a separate bill, H.R. 13592, which was reported by the House Ways and Means Committee (H. Rept. No. 95-1679, October 2, 1978).

<sup>4</sup> Under current sec. 6041, the IRS takes the position (in Rev. Rul. 76-231, *supra*) that employers also must report to the IRS charge account tips paid over to employees but not reported to the employer by the employees.

determining the employer's own income tax liabilities, to maintain charge receipts, records of amounts received by the employer from credit card companies, and records of aggregate payments to employees of charge account tips). Also, the Act does not affect any recordkeeping, reporting, or return requirements imposed on employers pursuant to section 6051 with respect to tips included in statements furnished by employees to the employer pursuant to section 6053(a).

This provision of the Act does not affect the present-law authority and power of the IRS to audit individuals with respect to their income from tips.

#### ***Effective date***

This provision applies to payments made after December 31, 1978.

#### ***Revenue effect***

This provision has the effect of revoking Revenue Rulings 75-400 and 76-231. If the employer reporting requirements contained in these rulings were to take effect, increases in budget receipts could be substantial. Inasmuch as this revenue is not being collected at the present time, no change in budget receipts is anticipated.

## **2. Tax Court Small Tax Case Procedures and Authority of Commissioners (sec. 502 of the Act and secs. 7456 and 7463 of the Code)**

### ***Prior law***

Taxpayers who file a petition with the Tax Court for a redetermination of income, estate, or gift tax deficiencies or overpayments have the option of having their cases heard as small tax cases under an expedited and simplified procedure (sec. 7463). The option, however, is available only where the amount of the deficiency, or claimed overpayment, does not exceed \$1,500, and where the cases are approved by the Tax Court. Trials of these cases are conducted informally. The rules of evidence are relaxed and neither party is required to file a brief. In addition, neither party may appeal, and decisions in these cases are not treated as precedents for any other case or purpose.

Typically, small tax cases are heard by commissioners appointed by the chief judge of the Tax Court (sec. 7456(c)). However, the law which provides for the appointment of commissioners does not specifically authorize them to administer oaths, issue subpoenas or examine witnesses. Under prior law, judges and certain other employees were authorized to administer oaths and issue subpoenas, but only judges were authorized to examine witnesses (sec. 7456(a)).

Following the hearing in small tax cases, the commissioners file reports which, upon review by the chief judge, may be adopted as reports of the Court. After a report is filed by the Court, a decision will be entered. The decision is based on the report and is comprised of a computational determination of the deficiency or overpayment.

Under prior law, the decision in a small tax case had to be entered by a judge, rather than by a commissioner, in accordance with the report of the Tax Court (sec. 7459(a)).

### ***Reasons for change***

The Congress believes that by increasing the jurisdictional amount for electing the Tax Court small case procedure from \$1,500 to \$5,000, more taxpayers will be able to take advantage of that expeditious and simplified procedure for handling tax disputes. In addition, it will provide a means of relieving the regular judges of part of an extremely heavy workload. The Congress also believes that, in order to clarify prior law and improve the administration of small tax cases, the authority of commissioners to conduct proceedings in small tax cases, and to file reports and to make decisions with respect to such proceedings, should be made specific.

### ***Explanation of provision***

The Act, in general, increases the jurisdictional amount for election of the small case procedure from \$1,500 to \$5,000.<sup>1</sup> In the case of a

<sup>1</sup> This provision was added to the Revenue Act of 1978 by a Senate floor amendment. The provision was the subject matter of a separate bill, H.R. 13092, which was reported by the House Ways and Means Committee (H. Rept. No. 95-1609, September 22, 1978) and passed by the House on October 10, 1978.

deficiency or overpayment in income taxes, the jurisdictional amount is applicable to each taxable year in dispute. In the case of a gift tax deficiency or overpayment, the jurisdictional amount is applicable with respect to each calendar year. Finally, in the case of an estate tax deficiency or overpayment, the jurisdictional amount is applicable to the total amount of deficiency or overpayment in dispute.

Use of this procedure would continue to be optional with the taxpayer unless the Tax Court decided before the hearing that the case should be heard under normal procedures and should be subject to appeal. Presently, the Tax Court rules provide that the Commissioner of Internal Revenue may file a motion requesting that a small tax case be removed from that category. In view of the increase in the small case jurisdictional amount to \$5,000, it is contemplated that the Tax Court will give careful consideration to a request by the Commissioner of Internal Revenue to remove a case from the small case procedures when the orderly conduct of the work of the Court or the administration of the tax laws would be better served by a regular trial of the case. Thus, in some situations, proper Court management may require the removal of a case from the small case procedures so that it can be consolidated with a regular case involving common facts or a common issue of law. Similarly, removal of the case from the small case category may be appropriate where a decision in the case will provide a precedent for the disposition of a substantial number of other cases or where an appellate court decision is needed on a significant issue.

Most of the small tax cases are handled by commissioners. It is contemplated that such cases will, in general, continue to be tried before the commissioners, with the Court continuing to have the power to authorize the commissioners to hear other cases (e.g., small tax cases where the taxpayers have not elected the simplified procedures), as was the situation after the enactment of the Tax Reform Act of 1969.

In order to alleviate any uncertainty which existed under prior law as to the authority of commissioners to administer oaths, issue subpoenas, and to prepare reports of small tax cases proceedings that they conduct, the Act expressly authorizes commissioners to perform such functions and duties. In addition, in order to further clarify the law with respect to the authority of commissioners, the Act authorizes commissioners to examine witnesses. Finally, under the Act, the Tax Court may authorize a commissioner to enter a decision in a small tax case proceeding subject to such conditions of review as the Court may impose by an appropriate rule, directive or order, whether or not published.

### ***Effective date***

The provision increasing the jurisdictional amount in small tax cases from \$1,500 to \$5,000 will become effective on the first day of the first calendar month beginning more than 180 days after the date of enactment (June 1, 1979). The provisions relating to the powers of commissioners are effective on the date of enactment (November 6, 1978).

### ***Revenue effect***

The provision is not expected to have any revenue effect.

### **3. Disclosure of Tax Return Information to the Department of Justice in Tax Administration Matters (sec. 503 of the Act and sec. 6103(h) of the Code)**

#### ***Prior law***

Under present law, in tax administration matters, returns and return information are generally made available to attorneys of the Department of Justice (including United States attorneys) in preparation for any proceeding (or investigation which may result in such a proceeding) before a Federal grand jury or any Federal or State court. One of the requirements to be met before the return is made available in these situations is that the taxpayer whose return is the subject of disclosure either be or may be a party to the proceeding involved. The return of a third party could also be made available to the Department of Justice in preparation for tax proceedings where either the treatment of an item reflected on the return is or may be related to the resolution of an issue in the proceeding or the third party's return or return information relates or may relate to a transaction between the third party and the taxpayer whose tax liability is or may be at issue, and the return information pertaining to the transaction may affect the resolution of an issue of the taxpayer's liability. The disclosure of a third party return in a tax proceeding is subject to the same item and transactional tests, described above, except that the transactions must have a direct relationship to the resolution of an issue of the taxpayer's liability.

#### ***Reasons for change***

The substantial revisions made under the Tax Reform Act of 1976 to the section 6103 disclosure provisions resulted in some unintended administrative problems with regard to the disclosure of returns and return information to the Department of Justice in certain tax cases, and the Congress concluded that certain minor modifications were necessary to eliminate these problems.

#### ***Explanation of provision***

The Act modifies present law in three respects. First, the return of a taxpayer who is not a party to the proceeding may be made available to the Department of Justice if the proceeding arose out of, or in connection with, determining the taxpayer's civil or criminal tax liability or the collection of civil tax liability. The second modification makes it clear that disclosures of third party returns made to the grand jury in tax cases are investigative disclosures and, thus, not subject to the more restrictive requirements applicable to disclosures of third party returns in tax proceedings. The third modification allows disclosure of returns to officers and employees of the Department of Justice, rather than just the attorneys of the Department of Justice.



***Effective date***

These provisions became effective on November 6, 1978.

***Revenue effect***

These provisions will have no effect on revenues.

#### **4. Refund Adjustments for Amounts Held Under Claim of Right (sec. 504 of the Act and sec. 6411 of the Code)**

##### ***Prior law***

If a taxpayer includes in income for a prior year an amount received or accrued under a "claim of right," and it is determined in a later year that no right to the income existed, then a deduction may be allowed in the later year (rather than in the prior year) for the amount previously included in income. This situation may arise, for example, when a public utility bills its customers based on a temporary rate schedule and, after the rates are made final by a utility commission in a later year, must make rebates to its customers. The tax benefit (i.e., reduction in taxes for the later year) that is allowed because of this deduction is generally the greater of the tax reduction that would be realized by treating the item as a deduction in (1) the prior year in which it originally was included in income, or (2) the later year in which it was discovered that the right to the income did not exist (sec. 1341). If the greater tax benefit is realized by treating the item as a deduction in the prior year, the tax benefit may be greater than the entire tax liability otherwise due in the later year. If this is the case, the excess benefit is treated as an overpayment of tax and is refundable. Under prior law, however, this refund might not be received for several years, since it was treated as an overpayment of tax for the later year and could be subject to audit along with the later year's return.

If a taxpayer incurs a net operating loss which he carries back to an earlier taxable year, the taxpayer may apply under section 6411 of the Code for a tentative refund of the tax paid for the earlier year. The Internal Revenue Service generally must make the refund after a limited examination of the application and within 90 days after the application is filed. Under prior law, this procedure was not available for refunds of overpayments of tax which resulted from recomputing a prior year's tax under a claim of right adjustment.

##### ***Reasons for change***

The adjustment of a later year's tax liability by recomputing the tax for a prior year in which an item was erroneously included in income has an effect similar to a net operating loss carryback to the prior year. The Congress believed that the net operating loss tentative refund procedures should be extended to apply to such a recomputation.

##### ***Explanation of provision***

The Act provides that a taxpayer may apply for a tentative refund of the amount of an overpayment for a taxable year that is attributable to a claim of right adjustment in which the tax for a prior year is recomputed. The application for a tentative refund may not be filed before the taxpayer has filed its income tax return for the taxable

year, and must be filed within 12 months after the close of the taxable year. The Act specifies certain information that must be provided in connection with the application.

Within 90 days after the application is filed (or, if later, within 90 days after the last day of the month in which the tax return for the year with respect to which the overpayment occurs must be filed, including extensions), the Secretary of the Treasury must review the application, determine the amount of the overpayment and apply, credit, or refund the overpayment to the taxpayer (unless the application contains errors in computation or material omissions).

This application for tentative refund will be administered in a manner similar to the manner prescribed under present law for tentative refunds due to carryback of net operating losses, investment tax credit, etc. Thus, special rules may need to be prescribed by the Secretary of the Treasury to take into account special problems involving consolidated returns.

#### ***Effective date***

The provision applies to tentative refund claims filed on and after November 6, 1978.

#### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million annually.

## **B. ESTATE AND GIFT TAX PROVISIONS**

### **1. Jointly-owned Farms and Closely Held Businesses (sec. 511 of the Act and sec. 2040 of the Code)**

#### ***Prior law***

In general, Federal estate tax law provides that on the death of a joint tenant the entire value of the property owned in joint tenancy is included in a decedent's gross estate except for the portion attributable to the consideration furnished by the survivor. For this purpose, the services performed by a wife in connection with the operation of a jointly owned farm or other business usually were not considered to constitute consideration furnished by the wife. Generally, during a marriage the income derived from a jointly operated business is treated under local law as belonging to the husband if the common law rule applies within the applicable jurisdiction. The estate tax treatment of services rendered by a wife as not constituting consideration furnished for the acquisition of jointly owned property was similar in effect to the local property law treatment of joint ownership interests.

In the case of certain trade or business activities conducted jointly in the form of a family partnership, the partnership interest held by the surviving spouse will not be included in the deceased spouse's gross estate. In this situation, because the husband and the wife chose to operate the business as a partnership, the effect is that the services performed by the surviving spouse in connection with the family owned business are taken into account, by reason of the profit-sharing ratio, as consideration furnished for the purchase of jointly owned property used in the trade or business if a partnership is used to conduct business.

Under the Tax Reform Act of 1976, one-half of the value of a qualified joint interest is included in the gross estate of a decedent regardless of which joint tenant furnished the consideration for acquisition of the property. An interest is treated as a qualified joint interest only if the following requirements are satisfied: (1) the interest must have been created by the decedent, the decedent's spouse, or both; (2) in the case of personal property, the creation of the joint interest must be a completed gift for gift tax purposes; (3) in the case of real property, the donor must have elected to treat the creation of the joint tenancy as a taxable event for gift tax purposes; and (4) the joint tenants cannot be persons other than the decedent and the decedent's spouse.

#### ***Reasons for change***

The Congress believed that the performance of services by a wife in connection with a jointly owned and operated farm or other business should be taken into account as consideration furnished under the estate tax law and without regard to whether the creation of the inter-

est is treated as a gift for gift tax purposes. The Congress believed that this is necessary to avoid differences in treatment for cases which are substantially identical except for formally arranging the business operation in a proper form, such as a family partnership, so that such services are given some recognition.

### ***Explanation of provision***

The Act provides a special elective rule for excluding a portion of the value of certain jointly owned property used in a farm or other business in which the surviving spouse materially participated. The exclusion is based on the number of years the surviving joint tenant **materially participated in the business. Material participation** is to be determined in a manner similar to that used under section 1402(a)(1), **relating to net earnings from self-employment. The provision applies only to a joint interest in property held by a husband and wife.**

The amount excludable is equal to the sum of the amount determined by applying a percentage rate of 2 percent for each year the surviving spouse materially participated in the business (not to exceed 50 percent) to the excess of the value of the joint interest (as determined for estate tax purposes) over the amount attributable to the original consideration furnished by both spouses and the amount attributable to the original consideration furnished by the surviving spouse. For this purpose, the amount attributable to the original consideration consists of the amount of that consideration plus assumed appreciation at the rate of 6 percent simple interest for the period of investment of the consideration.

The aggregate amount by which the value of the decedent's gross estate may be reduced by exclusions under this provision is \$500,000, and the provision may not result in the inclusion in the decedent's gross estate of less than 50 percent of the value of the eligible joint interest.

The provision applies if elected by the executor of the estate not later than the time for filing the estate tax return (including extensions) and in the manner prescribed under Treasury regulations.

### ***Effective date***

The provision applies with respect to estates of decedents dying after December 31, 1978.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million in fiscal year 1979, by \$41 million in fiscal year 1980, and by \$48 million in fiscal year 1983.

## **2. Treatment of Certain Interests Held by Decedent's Family for Purposes of Extension of Time for Payment of Estate Tax (sec. 512 of the Act and sec. 6166 of the Code)**

### ***Prior law***

Under Code section 6166, as added by the Tax Reform Act of 1976, Code (sec. 6166) provides a 15-year period is provided for the payment of the estate tax attributable to the decedent's interest in a closely held business (including a farm). Under this provision, the executor may elect to defer principal payments for up to 5 years from the due date of the estate tax return. However, interest for the first 5 years is payable annually. Thereafter, pursuant to the executor's initial election, the principal amount of the estate tax liability may be paid in from 2 to 10 annual installments. A special 4 percent interest rate is allowed on the estate tax attributable to the first \$1 million of closely held business property, and interest on amounts of estate tax in excess of this amount is at the regular rate for interest on deferred payments (currently 6 percent).

In order to qualify for this deferral and installment payment treatment, the value of the closely held business (or businesses) included in the decedent's estate must exceed 65 percent of the value of the gross estate reduced by allowable expenses, indebtedness, and losses. For this purpose, the term "interest in a closely held business" means an interest as sole proprietor in a trade or business; an interest as a partner in a partnership having not more than 15 partners, or in which the decedent owned 20 percent or more of the capital; or ownership of stock in a corporation having not more than 15 shareholders, or in which the decedent owned 20 percent or more in value of the voting stock. In determining the number of shareholders or partners each individual is generally counted once without regard to any attribution rules (such as attribution between father and son). Certain interests held by a husband and wife are treated as held by one shareholder or partner.

If a decedent's gross estate includes more than 20 percent of the value of each of two or more closely held businesses, the businesses can be treated as a single closely held business in determining whether the 65 percent test is satisfied.

A 10-year extended payment provision is also provided for estate tax attributable to a closely held business where a lesser proportion of the estate is represented by its value (sec. 6166A). Under this 10-year extension, the value of the business must be in excess of either 35 percent of the value of the gross estate or 50 percent of the taxable estate. In addition, the Internal Revenue Service is authorized to permit discretionary annual extensions of up to 10 years to pay estate tax where reasonable cause for an extension exists (sec. 6161(a)(2)). Prior to the Tax Reform Act of 1976, the 10-year discretionary extension was available only in the case of "undue hardship". Under both of these

extensions, interest is payable at the regular rate rather than the special 4-percent rate.

### ***Reasons for change***

The Congress believes that in determining whether a business is "closely held" for purposes of qualifying for the extended payment period where the 65 percent test is satisfied, attribution rules should be applied to permit stock or partnership interests held by the decedent's immediate family to be treated as held by the decedent in counting the number of shareholders or partners for purposes of determining qualification. In addition, these attribution rules should be applied, in the case of partnership interests and nonmarketable stock to determine if 20 percent of the business was included in the decedent's estate. Where the attribution rules are used to meet the 20 percent test, a 10-year deferral with interest payable at the regular rate will be allowed.

### ***Explanation of provision***

The Act applies attribution rules for purposes of calculating the number of shareholders in a corporation or partners in a partnership in determining eligibility for the 15-year extended payment provision for estate tax attributable to a closely held business (sec. 6166).<sup>1</sup> Under the Act, stock or partnership interests held by the decedent's family (e.g., father, mother, spouse, brothers, sisters, and descendants) will be treated as held by a single shareholder or partner, as the case may be. In applying the attribution rules, all stock or partnership interests held by a member of the decedent's family, either directly or indirectly through a corporation, partnership, estate, or trust are to be attributed to the decedent.<sup>2</sup>

In addition, the Act allows an executor to elect to apply the same attribution rules in order to determine whether at least 20 percent of the capital interest or value of voting stock in a business is included in the decedent's gross estate. However, in the case of stock, this attribution provision may be elected only if, at the time of the decedent's death, there was no market on a stock exchange or in an over-the-counter market for the stock. If an executor makes an election under this provision, then the extended payment period for the estate tax due cannot exceed 10 years, and the special 4 percent interest rate will not apply.

<sup>1</sup> This provision was added to the Revenue Act of 1978 by a Senate floor amendment. The provision was included in a separate bill, H.R. 12578, which was reported by the House Ways and Means Committee (H. Rept. No. 95-1286, June 12, 1978) and passed by the House on September 12, 1978.

<sup>2</sup> Code section 6166(b)(2)(C) sets forth the applicable indirect ownership attribution rules.

In addition, under section 6166(b)(2)(B), certain interests held jointly by a husband and wife are treated as owned by one shareholder or partner, as the case may be. Thus, if a decedent's brother and the brother's wife hold stock in a corporation as joint tenants (and own no other stock), the decedent, his brother, and his brother's wife will be treated as one shareholder, for purposes of determining the number of shareholders in the corporation. Also, the stock held by the brother and his wife will be treated as included in the decedent's gross estate for purposes of applying the 20-percent test.

***Effective date***

This provision applies with respect to the estates of decedents dying after the date of the enactment of the Act.

***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.



### **3. Subordination of Special Liens for Estate Tax Attributable to Special Valuation Property (sec. 513 of the Act and sec. 6325 of the Code)**

#### ***Prior law***

Present law provides an estate tax election pursuant to which certain qualifying property used in connection with a farm or other closely held business may be valued on the basis of its actual use rather than at its fair market value based on the highest and best use of the property (sec. 2032A). If this election is made, a special lien arises on the property (sec. 6324B) and continues until the earlier of the recapture of the tax benefit or the termination of potential liability for recapture (*i.e.*, the death of a qualified heir, or the expiration of a 15-year period from the decedent's death). The Treasury Department is to issue regulations under which other security could be substituted for the real property.

Also, under present law, the Internal Revenue Service may agree to the subordination of a prior tax lien to a subsequent security interest if certain conditions are satisfied (*i.e.*, an amount equal to the security interest is paid over or the Service believes that subordination of the tax lien would increase the amount ultimately realizable).

Under prior law, the subordination of lien provision did not specifically deal with the circumstances under which the special lien for estate taxes attributable to special valuation property could be subordinated.

#### ***Reasons for change***

The Congress believes that the subordination of lien provision should be clarified to permit the subordination of the special tax lien in appropriate cases. In this way, the purpose of providing the special estate tax valuation for farm and closely held business real property will not be frustrated by unduly restricting an heir's ability to obtain working capital and other financing because the lien for such financing would be inferior to the pre-existing special tax lien.

#### ***Explanation of provision***

The Act permits the subordination of the special lien for the recapture of the estate tax savings attributable to the special valuation of farm or closely held business real property. The special lien may be subordinated if the Secretary of the Treasury is satisfied that the interests of the United States are protected adequately after subordination.

#### ***Effective date***

The provision applies with respect to estates of decedents dying after December 31, 1976.

#### ***Revenue effect***

It is estimated that the provision will have a negligible revenue effect.

#### **4. Time To Amend Governing Instruments of Charitable Split Interest Trusts (sec. 514 of the Act and secs. 170, 2055, and 2522 of the Code)**

##### ***Prior law***

The Tax Reform Act of 1969 imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., part charitable and part noncharitable). In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined at least annually).

Many persons created instruments which did not comply with these new requirements. As a result, Congress provided, as early as 1974, that the governing instruments of charitable remainder trusts could be amended to meet the new rules within certain time limitations for estate tax purposes. The latest extension of these time limitations was made by the Tax Reform Act of 1976 which permitted amendment of charitable remainder trusts until December 31, 1977, in order to qualify the trust for the charitable estate tax deduction. However, it provided this relief only in the case of the charitable deduction for estate tax purposes and only for remainder interests passing to charity. No relief was provided for the charitable deduction for income or gift tax purposes or for "income" interests passing to charity for income, gift or estate tax purposes.

##### ***Reasons for change***

The Congress believes that the persons creating charitable lead trusts should be granted an opportunity to amend the trust instrument in order to comply with the requirements of the 1969 Act similar to the opportunity that Congress has extended to charitable remainder trusts. In addition, Congress believes that the opportunity to amend the instruments of charitable split interest trusts should be extended to the charitable deduction for income and gift tax purposes.

##### ***Explanation of provision***

The Act extends until December 31, 1978, the time to amend (or to commence judicial proceedings to amend) instruments establishing charitable remainder trusts which were executed before December 31, 1977, in order to conform such instruments to the requirements of the Tax Reform Act of 1969 for a charitable deduction to be allowed for estate tax purposes. The Act also provides that instruments establishing charitable lead trusts, and charitable remainder trusts in the case of income and gift taxes, which were created before December 31, 1977, may be amended to comply with the requirements of the 1969 Act if the

instrument is amended (or judicial proceedings to amend are commenced) by December 31, 1978.

***Effective date***

The provision is effective on the date of enactment (November 6, 1978).

***Revenue effect***

This provision will reduce budget receipts in fiscal year 1979 by \$15 million. (This includes liabilities for prior years.)

## **5. Deferral of Carryover Basis Rules (sec. 515 of the Act and secs. 691 and 1023 of the Code)**

### ***Prior law***

Under the Tax Reform Act of 1976, the basis of property passing from a decedent is "carried over" from the decedent to the estate or beneficiaries for purposes of determining gain or loss for sales and exchanges by the estate or beneficiaries. Under prior law, the basis of property passing from a decedent was generally stepped up or down to its value on the date of the decedent's death. The carryover basis provisions were to apply to property passing from decedents dying after December 31, 1976.

### ***Reasons for change***

A number of administrative problems concerning the carryover basis provisions have been brought to the attention of the Congress. Administrators of estates have testified that compliance with the carryover basis provisions has caused a significant increase in the time required to administer an estate and has resulted in raising the overall cost of administration. Moreover, the Congress believes that it should thoroughly review the basic concept of carryover basis in addition to considering its effect on the administration of estates. The Congress believes that the effective date should be postponed in order to review the provisions before they become effective.

### ***Explanation of provisions***

The Act postpones the effective date of the carryover basis provisions so that they will only apply to property acquired from decedents dying after December 31, 1979. For property passing or acquired from a decedent dying before January 1, 1980, the basis of property will be its fair market value at the date of the decedent's death or at the applicable valuation date if the alternate valuation provision is elected for estate tax purposes.

The Act also postpones the changes made by the 1976 Act with respect to the computation of the section 691(c) deduction for estate taxes attributable to the inclusion of items of income in respect of a decedent in a decedent's gross estate. As a result, the section 691(c) deduction is determined, for the three year postponement period, only with regard to Federal estate tax, and is based on the highest marginal, rather than the average rate of tax.

### ***Effective date***

The amendments are to take effect as if included in the Tax Reform Act of 1976. Thus, the postponement applies to property passing or acquired from a decedent dying after December 31, 1976, and before January 1, 1980.

### ***Revenue effect***

This provision will reduce budget receipts by \$36 million in fiscal year 1979, \$93 million in fiscal year 1980, and \$190 million in fiscal year 1983.

## C. EXCISE TAX PROVISIONS

### 1. Reduction in Rate of Excise Tax on Investment Income of Private Foundations (sec. 520 of the Act and sec. 4940 of the Code)

#### *Prior law*

The Tax Reform Act of 1969 imposed a 4-percent excise tax on the net investment income of all private foundations (sec. 4940 of the Code). A private foundation's net investment income is the sum of (1) its gross investment income and (2) the full amount of its net capital gains, this sum being reduced by the expenses paid or incurred in earning the gross investment income. Gross investment income includes interest, dividends, rents, and royalties, but does not include unrelated business income which is taxed under section 511.

#### *Reasons for change*

The 4-percent excise tax on investment income of private foundations was enacted 9 years ago. This tax has produced more than twice the revenue needed to finance the operations of the Internal Revenue Service with respect to tax-exempt organizations.

Because of the operation of the private foundation charitable distribution provisions (sec. 4942(d)), this tax reduces the minimum amount that private foundations are required to spend or grant for charitable purposes. In many cases, the tax actually has reduced charitable expenditures.

This experience with the tax and its impact on charitable expenditures has led the Congress to conclude that it is appropriate to cut the tax rate in half.

The Congress also is concerned that the Internal Revenue Service devote adequate resources to the administration of the provisions of the tax law relating to tax-exempt organizations. The excise tax was instituted in the Tax Reform Act of 1969 in order to assure the availability of such resources. In section 1052 of the Employee Retirement Income Security Act of 1974, the Congress established a separate office in the IRS to effectively deal with this area and made a permanent authorization of appropriations to assure further the availability of sufficient resources to administer these provisions. The change in tax rate made by this Act does not reduce the amount of that permanent authorization.

The Congress expects and intends that the Internal Revenue Service report annually to the tax-writing committees on the extent to which audits are conducted as to the tax liabilities of exempt organizations, the extent to which examinations are made as to the continued qualification of such organizations for exempt status, the extent to which IRS personnel are given initial and refresher instruction in the relevant portions of the law and administrative procedures, the extent to which the IRS cooperates with, and receives cooperation from,

State officials with regard to supervision of charities and other tax-exempt organizations, the costs of maintaining such programs at levels which would produce proper compliance with the laws, the amounts requested by the Executive Branch for the maintenance of those programs, and the reasons for any difference between the needed funds and the requested amounts. Also, the Internal Revenue Service is to notify the tax-writing committees of any administrative problems that the IRS experiences in the course of its enforcement of the internal revenue laws with respect to exempt organizations.

***Explanation of provision***

The provision reduces the rate of tax imposed on the net investment income of domestic private foundations from 4 percent to 2 percent.<sup>1</sup>

***Effective date***

The provision applies to taxable years beginning after September 30, 1977.

***Effective date***

This provision will reduce budget receipts by \$40 million per year in fiscal years 1979–1983.

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<sup>1</sup> This provision was added to the Revenue Act of 1978 by a Senate Finance Committee amendment. The provision was the subject matter of a separate bill, H.R. 112, which was reported by the House Ways and Means Committee (H. Rept. No. 95–842, January 19, 1978) and passed by the House on February 28, 1978. This provision was also reported by the Finance Committee as part of H.R. 112 (S. Rept. 95–790, May 9, 1978) and passed by the Senate, with amendments, on August 23, 1978.

## **2. Excise Tax on Certain Gaming Devices (sec. 521 of the Act, and secs. 4461 and 4464 of the Code)**

### ***Prior law***

Prior law imposed an annual occupational excise tax of \$250 on each slot machine or other coin-operated gaming device (sec. 4461 of the Code). If a State imposed a similar tax, the State tax was credited dollar-for-dollar against the Federal tax up to a maximum of 80 percent of the Federal tax (sec. 4464).

### ***Reasons for change***

The Commission on Review of the National Policy Toward Gambling recommended that State governments be given sole jurisdiction with respect to legalized gaming activity.

The availability of the State tax credit facilitates the raising of State revenues through State taxes on slot machines. Under State law in Nevada, an amount equal to the State tax credit is used for educational purposes.

For these reasons, the Congress believes that the State credit should be increased to 95 percent of the Federal tax for two years, and that the Federal tax should be repealed as of July 1, 1980.

### ***Explanation of provisions***

The Act increases the State credit against the annual Federal excise tax imposed on slot machines from 80 to 95 percent of the Federal tax amount. The increase in the State credit applies for years ending June 30, 1979, and June 30 1980. The Act repeals the Federal excise tax as of July 1, 1980.

### ***Effective date***

The provision applies to Federal excise tax imposed on slot machines after June 30, 1978.

### ***Revenue effect***

This provision will reduce budget receipts by \$5 million in fiscal year 1979, \$6 million in fiscal year 1980, and \$7 million in fiscal year 1983.

### **3. Exemption From Private Foundation Excise Tax for Failure to Distribute Income (sec. 522 of the Act and sec. 4942 of the Code)**

#### ***Prior law***

Under present law, the term "private information" means any charitable, educational, religious, or other organization described in section 501(c)(3), *other than* certain specified categories of organizations (sec. 509 (a) of the Code). These specified categories (known as "public charities") include churches, schools, hospitals or certain medical research organizations, certain other organizations which receive specified "public" support, and organizations which are "supporting" organizations to other public charities. For this purpose, under Treasury regulations, the term "hospital" does not include "convalescent homes or homes for children or the aged, nor does the term include institutions whose principal purpose or function is to train handicapped individuals to pursue some vocation" (Treas. reg. sec. 1.170A-9(c)(1)).

In addition to other restrictions on private foundations, a private foundation is required to make annual expenditures or distributions for exempt purposes generally equal to the net income of the private foundation. However, an exception to this rule is provided for certain private foundations known as "operating foundations." A private foundation may qualify as an "operating" foundation if it spends directly for the active conduct of its exempt-purpose activities amounts which are at least equal to 85 percent of its adjusted net income, and which are at least equal to  $3\frac{1}{3}$  percent of its net endowment assets, or if the foundation meets certain other tests (sec. 4942(j)(3)).

In general, the rules relating to income tax deductions by individuals for contributions to public charities or to private operating foundations are more favorable to the donor than the rules relating to the deductibility of contributions to private non-operating foundations (sec. 170).

#### ***Reasons for change***

The Congress believes that organizations which provide long-term care facilities for disabled and needy persons, widows, and children have a greater need to accumulate a portion of their income for future use in their charitable purposes than other private foundations. However, the Congress believes that these organizations should be required to spend currently a substantial amount on the care of these disadvantaged persons. While Congress believes that it is appropriate to relax the normal distribution requirements applicable to private foundations in these cases, the Congress does not believe that contributors to these organizations should be entitled to the more favorable rules on charitable contributions.



***Explanation of provisions***

Under the Act, and only for purposes of the distribution requirements of section 4942, an "operating foundation" includes a private foundation which, on or before May 26, 1969, and continuously thereafter to the close of each taxable year, operates and maintains as its principal functional purpose facilities for the long-term care, comfort, maintenance, or education of permanently and totally disabled persons, elderly persons, needy widows, or children provided the foundation meets the distribution requirements applicable to operating foundations (sec. 4942(j)(3)(B)(ii)). This requires the foundation to make qualifying distributions, directly for the active conduct of its exempt function, of not less than 66 $\frac{2}{3}$  percent of its minimum investment return. Since this rule applies only for purposes of the distribution requirement, the rules for deductibility of contributions to such an organization will be determined as if the organization is a nonoperating private foundation (unless it meets the regular definition of a public charity or operating foundation).

***Effective date***

The provision is effective for taxable years beginning after December 31, 1969.

***Revenue effect***

This provision will reduce receipts by less than \$1 million annually.

## **D. OTHER TAX PROVISIONS**

### **1. Employment Tax Status of Independent Contractors and Employees (sec. 530 of the Act)**

#### ***Prior law***

With certain limited statutory exceptions, the classification of particular workers or classes of workers as employees or independent contractors (self-employed persons) for purposes of Federal employment taxes, is made under common law rules. A determination of whether an employer-employee relationship exists is important because a certain amount of wages paid to employees generally is subject to Social Security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and unemployment taxes are imposed on the employer under the Federal Unemployment Tax Act (FUTA). On the other hand, payments to independent contractors are subject to the tax on self-employment income (SECA). In addition, Federal income tax must be withheld from compensation paid to employees, but payments to independent contractors are not subject to withholding.

Generally, the basis for determining whether a particular worker is an employee or independent contractor is the common law test of control. Under Treasury regulations, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished," the relationship of employer and employee is deemed to exist. On the other hand, the absence of a right to control generally indicates that the person performing the services is an independent contractor. In interpreting the Treasury regulations, twenty factors are used in determining whether workers are employees or independent contractors.

#### ***Reasons for change***

In the late 1960s, the IRS increased its enforcement of the employment tax laws. Previously, employment tax audits had been superficial or sporadic and only occasionally entailed examination of employment status issues. Many controversies developed between taxpayers and the Service about whether individuals treated as independent contractors should be reclassified as employees. If the IRS prevailed on a reclassification, the taxpayer became liable for employment taxes— withholding, social security, and unemployment—which neither had been withheld nor paid to the Treasury.

In some cases, the assessments were for liabilities already satisfied directly by workers, who paid their own income and self-employment taxes. The IRS has agreed to allow taxpayers certain income tax and FICA-SECA offsets, if they provide the Service with their workers' names and social security numbers. However, many taxpayers lack

such information about their workers and cannot benefit from this procedure.

Many taxpayers have complained that proposed reclassifications involve a change of position by the Internal Revenue Service in interpreting how the common law rules apply to their workers or industry. Some taxpayers have prior private letter rulings or technical advice memoranda from the Service in which the Service said that the workers were independent contractors. Other taxpayers have pointed to prior audits in which their treatment of workers as independent contractors was not challenged. Before the 1970s, however, most audits did not focus on employment tax status determinations; so most taxpayers relied on their own judgment, industry practice, or, in a few industries, published Revenue Rulings.

During the 1976 Tax Reform Act conference, House and Senate conferees included in the Statement of Managers a request that the IRS "not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years" until the completion of a study by the staff of the Joint Committee on Taxation on the problems of classifying persons as employees or independent contractors.

The Congress believes that it is appropriate to provide interim relief for taxpayers who are involved in employment tax status controversies with the Internal Revenue Service, and who potentially face large assessments, as a result of the Service's proposed reclassifications of workers, until the Congress has adequate time to resolve the many complex issues involved in this area.

### ***Explanation of provisions***

#### ***General***

The Act provides an interim solution for controversies between the Internal Revenue Service and taxpayers involving whether certain individuals are employees by—

- (1) terminating certain employment tax liabilities for periods ending before January 1, 1979,
- (2) allowing taxpayers, who had a reasonable basis for not treating workers as employees in the past, to continue such treatment for periods ending before January 1, 1980, while the Congress works on a comprehensive solution, without incurring employment tax liabilities, and
- (3) prohibiting the issuance of Treasury regulations and Revenue Rulings on common law employment status before 1980.<sup>1</sup>

#### ***Termination of certain pre-1979 employment tax liability***

The Act provides relief from employment tax liability to certain taxpayers involved in employment tax status controversies with the Internal Revenue Service as a result of the Service's proposed reclassifications of workers, whom taxpayers have considered as having independent contractor status or some other status (e.g., customer), as employees. For purposes of determining such taxpayers' employment

<sup>1</sup> The text of this provision, which originated as a Senate floor amendment, is similar to a separately reported bill, H.R. 14159, which was reported by the House Ways and Means Committee (H. Rept. 95-1748, October 10, 1978).

tax liabilities, the Act provides that workers shall be deemed not to be the taxpayers' employees, unless the taxpayers had no reasonable basis for not treating the workers as employees.

Liabilities terminated under the Act are those for Federal income tax withholding, Social Security (FICA), and unemployment (FUTA) taxes for any period ending before January 1, 1979, during which the taxpayers did not treat the workers as employees. It is not necessary that a taxpayer have treated workers other than as employees for all pre-1979 periods in order to qualify for relief. A taxpayer who treated workers as employees for some pre-1979 periods, may obtain relief for other pre-1979 periods when they were treated other than as employees, provided there was a reasonable basis for such treatment. (However, an antiabuse rule, discussed later, denies relief for 1979 periods, if the taxpayers' treatment of workers other than as employees is inconsistent with the treatment of such workers for any period beginning after December 31, 1977.)

Generally, the Act terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. The Congress intends that this reasonable basis requirement be construed liberally in favor of taxpayers. In addition, the Act establishes several alternative statutory standards which constitute "safe havens," and which, when met, qualify a taxpayer for the termination of employment tax liability.

The first statutory reasonable basis standard is met if a taxpayer's treatment of an individual as not being an employee for a period was due to reasonable reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, or a ruling, for example, a "letter ruling," or a "determination letter," issued to the taxpayer. Under this test, the judicial precedent or published ruling upon which a taxpayer reasonably relied does not have to relate, necessarily, to the particular industry or business in which the taxpayer is engaged.

Under the second statutory "safe haven" standard, a taxpayer is treated as satisfying the reasonable basis test for the treatment of an individual as other than an employee for employment tax purposes, by showing reasonable reliance on a past Internal Revenue Service audit of the taxpayer. Such an audit need not have been for employment tax purposes. However, a prior audit would qualify as a "safe haven" basis for a taxpayer's reliance only if the audit entailed no assessment attributable to the taxpayer's treatment (for employment tax purposes) of individuals holding positions substantially similar to the position held by the individual whose treatment is at issue. A taxpayer does not meet this second test if in the conduct of a prior audit an assessment attributable to the taxpayer's treatment of an individual was offset by other claims asserted by the taxpayer.

The third statutory method for a taxpayer to establish a reasonable basis for the treatment of an individual as other than an employee is to show that such treatment coincided with a long-standing, recognized practice of a significant segment of the industry in which the individual whose status is at issue was engaged. This test does not require that a practice be uniform throughout an entire industry.

The three statutory methods for fulfilling the requirement that a taxpayer had a reasonable basis for the treatment of an individual as

other than an employee are not the exclusive ways of meeting the Act's reasonable basis requirement. A taxpayer who can demonstrate a reasonable basis for the treatment of an individual as other than an employee in some other manner also is entitled to termination of employment tax liabilities.

Termination of employment tax liabilities under the Act is made available to taxpayers who are under audit by the Internal Revenue Service or who are involved in administrative or judicial proceedings with respect to assessments based on employment status reclassifications. Relief also is extended to any claim for a refund or for a credit of any overpayment of an employment tax resulting from the Act's termination of liability, provided the claim is not barred on the Act's date of enactment by any law or rule of law.

Taxpayers who have entered into final closing agreements under section 7121 or compromises under section 7122 with respect to employment status controversies are ineligible for relief under the Act, unless they have not completely paid their liability. Thus, for example, a taxpayer who has agreed or compromised a liability for an amount which is to be paid in installments, but who still has one or more installment to pay, is relieved of liability for such outstanding installments. Taxpayers who settled employment status controversies administratively with the Internal Revenue Service or who unsuccessfully litigated such cases are eligible for relief, provided their claims are not barred by the statute of limitations or by the application of the doctrine of *res judicata*. However, an unsuccessful litigant in an employment status case who fulfills the Act's requirements, can avoid collection of any unpaid employment tax liabilities, regardless of the doctrine of *res judicata*.

Eligibility for relief for pre-1979 periods is to be determined independently of a taxpayer's eligibility for relief for any periods in 1979. With respect to pre-1979 periods, there is no requirement that the taxpayer file all Federal tax returns (including information returns), required to be filed with respect to an individual whose status is at issue on a basis, consistent with the taxpayer's treatment of such individual as not being an employee.

#### *Employment tax liability for 1979*

Until the Congress enacts legislation clarifying the employment tax status of individuals, taxpayers will remain uncertain about the proper treatment of many workers. Therefore, the Act allows taxpayers to continue to treat workers as other than employees through 1979, unless the taxpayers have no reasonable basis for not treating the workers as employees. However, in order to qualify for relief for 1979, the Act also provides that taxpayers must file all Federal tax returns (including information returns) required to be filed for periods after December 31, 1978, with respect to workers whose status is at issue, on a basis consistent with the taxpayers' treatment of the workers other than as employees. Thus, the Act prospectively relieves taxpayers of liabilities which they might incur during 1979. The Congress believes that work on formulating comprehensive legislation on the employment tax status controversy should be undertaken during this period.

Except for the filing requirement, taxpayers' eligibility for the prospective relief from potential 1979 liabilities is to be determined under the same tests and the same liberal interpretations of the tests which determine eligibility for pre-1979 relief.

It is expected that legislation developed during 1979 to clarify the employment tax status of individuals would become effective January 1, 1980, or the date of enactment of clarifying legislation, whichever is earlier, and would replace present law for all periods thereafter.

#### *Anti-abuse provision*

To prevent taxpayers from changing the way they treat workers for employment tax purposes solely to take advantage of the relief provisions, the Act denies relief in such circumstances. The Act prohibits the termination of any potential employment tax liability with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, and before January 1, 1980, if the taxpayer (or a predecessor taxpayer) has treated an individual holding a substantially similar position as an employee for any period beginning after December 31, 1977. The application of this provision to taxpayers and their predecessors is intended to prevent avoidance of this rule, for example, by reincorporations.

#### *Refunds or credits of overpayments*

The Act allows taxpayers at least a one-year period for filing claims for refunds or credits attributable to the relief provided in the Act. If a taxpayer's claim for refund or credit is not barred on the Act's date of enactment by any law or rule of law, the taxpayer will have at least until the date one year after the Act's date of enactment for filing a claim. If the taxpayer is entitled to a longer period under the general statute of limitations for filing such claims, the longer period applies.

Generally, taxpayers should file refund or credit claims asserting grounds for relief under the Act with the Internal Revenue Service. If the taxpayer already has an open claim filed with the Service, or is involved in litigation over such a claim with the Department of Justice, the original claim qualifies as a claim for relief under this provision, provided the taxpayer notifies either the Service or the Department of Justice, whichever is appropriate, within the proper time period, of the taxpayer's basis for relying on the Act for relief.

#### *Penalties and interest*

If a taxpayer is relieved of liability for any tax under this provision, any liability for interest or penalties attributable to such tax liability is forgiven automatically. This relief applies to all such interest and penalties for both pre-1979 and 1979 liabilities, whether charged directly against the taxpayer or personally against the taxpayer's officers.

#### *Status, liabilities and rights of individual employees and independent contractors*

The Act does not change in any way the status, liabilities and rights of an individual whose employment status is at issue.

*Prohibition against IRS Revenue Rulings and Regulations*

The Act prohibits the Department of the Treasury (including the Internal Revenue Service) from publishing any regulation or Revenue Ruling classifying individuals for purposes of employment taxes under interpretations of the common law. This prohibition becomes effective on the date of enactment of the Act and will remain in effect until January 1, 1980, or, if earlier, the effective date of any law subsequently enacted to clarify the employment status of individuals for purposes of employment taxes.

The prohibition applies to Revenue Rulings having precedential status but does not apply to the issuance of private letter rulings requested by taxpayers. Moreover, the prohibition does not extend to regulations or Revenue Rulings based on statutory provisions dealing with the employment tax status of particular workers, such as certain fishermen, which do not involve the application of common law standards; nor does the prohibition apply to the determination of matters such as effective dates, which do not entail issues of common law employment status for purposes of employment taxes.

*Effective date*

This provision was effective upon enactment (November 6, 1978).

*Revenue effect*

The revenue effect of this provision cannot be estimated because the provisions affects IRS-asserted employment tax liabilities which were contested by taxpayers in both administrative and judicial proceedings.

## **2. Tax Treatment of Cooperative Housing Corporations (sec. 531 of the Act and sec. 216 of the Code)**

### ***Prior law***

A tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid to the corporation which represent the tenant stockholder's proportionate share of allowable real estate taxes and interest relating to the corporation's land and buildings. (In addition, to the extent a tenant-stockholder uses depreciable property leased from the cooperative housing corporation in a trade or business or for the production of income, the tenant-stockholder is allowed to take depreciation deductions with respect to the stock the ownership of which gives the tenant-stockholder the right to lease such property.)

In general, for an organization to qualify to pass through these deductions to tenant-stockholders, 80 percent or more of the gross income of the cooperative housing corporation must have been derived from individual tenant-stockholders. However, for purposes of determining whether the 80 percent test has been satisfied, stock owned and dwelling units leased by governmental entities for the purpose of providing housing facilities are not taken into account. Further, banks and other lending institutions which obtain stock in a cooperative housing corporation through foreclosure are treated as tenant-stockholders for up to three years after the date of acquisition.

### ***Reasons for change***

The requirement that at least 80 percent of the gross income of a cooperative be derived from individual tenant-stockholders results in placing corporate sponsors of cooperative projects in a disadvantageous position when converting residential apartments to cooperative status because of the adverse tax consequences which result from the retention of unsold units. Unless the individual owners of the corporate sponsor are willing to assume the financial risks involved in holding the unsold shares, the corporation is unable to take back the shares from the cooperative corporation for resale without the risk of violating the 80 percent of gross income rule.

Consequently, Congress believed that there should be a relaxation of the rule that 80 percent or more of the income of the cooperative must come from individual tenant-stockholders in situations where buildings are being converted into housing cooperatives (or being constructed for use as housing cooperatives) by non-individual sponsors.

### ***Explanation of provision***

The Act provides that if a person who conveys the houses, apartment building or leasehold thereof to a cooperative housing corporation acquires stock in the corporation by purchase or foreclosure, together with a lease or right to occupy the house or apartment, such person would be treated as a tenant-stockholder for up to three years



from the date of acquisition. This provision would apply even though such person or any purchaser from such person could not occupy the apartment or house without prior approval of the corporation or its managing agent.

***Effective date***

This provision applies to stock acquired after November 6, 1978.

***Revenue effect***

The provision will reduce budget receipts by less than \$5 million annually.

### 3. Deposits in Certain Branches of Puerto Rican Savings and Loan Associations (sec. 540 of the Act and sec. 861 of the Code)

#### *Prior law*

U.S. citizens and resident aliens residing in Puerto Rico are, in general, subject to U.S. tax on all their income other than Puerto Rican source income (sec. 933). U.S. corporations operating in Puerto Rico which qualify under section 936 are entitled to a possessions credit against any U.S. tax on the foreign source income of their Puerto Rican businesses and on certain investment income from Puerto Rican sources (qualified possessions source investment income).

As a general rule, interest received from a U.S. corporation is treated as U.S. source income (sec. 861(a)(1)) and thus does not qualify for the special treatment provided for Puerto Rican source income of Puerto Rican residents (sec. 933) and possessions corporations (sec. 936) described above. However, interest paid by a domestic corporation is considered to be foreign source if less than 20 percent of the corporation's gross income is from sources within the United States (sec. 861(a)(1)(B)). If this requirement is met and 50 percent or more of the corporation's gross income is from Puerto Rican sources, then interest paid by the corporation is treated as from Puerto Rican sources in the same proportion as the corporation's gross income is from Puerto Rican sources. (*Cf.* Rev. Rul. 76-535, 1976-2 C.B. 219.)

As an exception to these rules, interest on deposits with a foreign branch of a U.S. commercial bank, including a branch located in Puerto Rico or another U.S. possession, is treated as income from sources within the foreign country or possession in which the branch is located (sec. 861(a)(1)(F); Treas. Reg. § 1.861-2(b)(5)). Consequently, interest paid by Puerto Rican branches of U.S. commercial banks generally qualifies for the special treatment afforded Puerto Rican residents and possessions corporations (provided, of course, it meets the other applicable conditions for such treatment).

However, this exception for foreign branches of U.S. commercial banks did not, under prior law, extend to foreign or possessions branches of U.S. savings and loan associations. Since this exception did not apply to Puerto Rican branches of U.S. savings and loan institutions, interest paid by those branches generally was treated as U.S. source income or, if less than 20 percent of the gross income of the savings and loan was from U.S. sources, the interest income could be treated as partially from sources within and without Puerto Rico in accordance with the proportion of the gross income of the savings and loan institution from sources within and without Puerto Rico. It was unclear under prior law whether these same source rules were to be applied for purposes of the special treatment provided Puerto Rican residents and possessions corporations. As a result, unless all the in-

come of the savings and loan association was from Puerto Rican sources, interest income received from the Puerto Rican branch of the savings and loan association (or, where applicable, a pro rata portion of the interest) might not have been from Puerto Rican sources for purposes of the exclusion for residents of Puerto Rico under section 933, and also might not have qualified for the possessions tax credit under section 936.

### ***Reasons for change***

The Congress believed that interest on deposits with Puerto Rican branches of U.S. savings and loans should receive the same treatment for purposes of the exclusion allowed residents of Puerto Rico under section 933 and the possessions tax credit under section 936 as does interest on deposits with a Puerto Rican branch of a U.S. commercial bank.

### ***Explanation of provisions***

The Act expands the exception to the source rule provided by section 861(a)(1)(F) for interest on deposits in foreign branches of U.S. commercial banks so that it also applies to interest on deposits or withdrawable accounts with foreign branches of U.S. savings and loan associations.<sup>1</sup> The principal purpose of this change is to make it clear that interest received from Puerto Rican branches of U.S. savings and loan associations is to be treated as Puerto Rican source income and thus qualifies for the special treatment afforded Puerto Rican source income received by Puerto Rican residents and for the tax credit afforded to possessions corporations.

### ***Effective date***

The provision applies to taxable years of the recipient of the interest beginning after the date of enactment (November 6, 1978). (The Congress did not intend that any inference be drawn as to whether or not interest paid by Puerto Rican branches of U.S. savings and loan associations was from Puerto Rican sources for purposes of the special tax treatment provided to Puerto Rican residents and possessions corporations prior to the effective date.)

### ***Revenue effect***

The provision will reduce budget receipts by less than \$5 million a year.

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<sup>1</sup> This provision was added to the Revenue Act of 1978 as a Senate Finance Committee amendment. The provision was also the subject matter of a separate bill, H.R. 13758, which was reported by the House Ways and Means Committee (H.Rept. 95-1745, October 6, 1978) and passed by the House on October 13, 1978.

#### **4. Taxation of Alaska Native Claims Settlement Act Corporations (sec. 541 of the Act and sec. 21 of the Alaska Native Claims Settlement Act)**

##### ***Prior law***

The Alaska Native Claims Settlement Act ("ANCSA"), 43 U.S.C. §§ 1601-28, settled the aboriginal land claims of Alaska Natives. ANCSA provided for the establishment of regional and village corporations, the shareholders of which are Alaska Natives. Under ANCSA, cash in the Alaska Native Fund of the Treasury is distributed to the regional corporations and is redistributed in part to the Native shareholders of the regional corporations and to the village corporations. Also, both the regional and village corporations have the right under ANCSA to select specified amounts of Alaska land from larger areas of land set aside under ANCSA for possible selection by them.

In many instances, a large part of the value of the land the corporations may select is in its potential for mineral exploitation. A number of regional corporations are understood to have entered into agreements with oil companies under which the companies agreed to explore the land and to provide information to the regional and village corporations to assist them in selecting the land with the greatest potential. The oil companies might then drill on the selected lands and receive a share of the oil extracted. The regional and village corporations have also incurred expenses in organizing, selecting land, and commencing business operations.

Section 21 of ANCSA provides a number of rules for the proper tax treatment of various aspects of the transactions contemplated by ANCSA. However, under prior law, the proper rules for the treatment of certain transactions were unclear. Questions were raised as to whether, when an oil company provided services, equipment and information to a regional corporation, the regional corporation realized income to the extent of the fair market value of those goods or services. It was also not clear whether the expenses of the regional and village corporations for exploring land were deductible, or were to be added to the basis of land which was selected. Finally, questions were raised as to whether or not the expenses incurred by the regional and village corporations in the early stages of their operations were nondeductible "start-up" or "pre-opening" expenses. This depended on whether or not the corporations were engaged in a trade or business at the time the expenses were incurred.

ANCSA provides that village corporations may be organized in certain villages with a population of as few as 25 Natives. In some instances, the Native shareholders may be closely related to one another and, if the corporation has sufficient passive income, it may meet the definitional requirements for a personal holding company (sec. 542) by operation of the stock attribution rules (sec. 544).

### ***Reasons for change***

When Congress enacted ANCSA, it recognized the unique status of the regional and village corporations by providing certain special tax rules. Although the Congress intended that these corporations would ordinarily be subject to general tax rules, unforeseen questions arose in connection with the organization and operation of these corporations which the Congress believed were best resolved through the prescription of additional special rules by legislation.

### ***Explanation of provisions***

The Act provides that, in the case of any Native corporation established pursuant to ANCSA, income for purposes of any form of Federal, State, or local taxation does not include the value of (1) the receipt, acquisition, or use of any resource information or analysis (including the receipt of any right of access to the information or analysis) relating to lands or interests in lands, or (2) the promise or performance by any person or by any Federal, State, or local government agency of any professional or technical services relating to the resources of lands or interests in land, including, but not limited to, services in connection with exploration on the lands for oil, gas, or other minerals. The lands to which the provision applies are those conveyed, selected but not conveyed, or available for selection under ANCSA.

In addition, income of these corporations generally does not include the value derived from the expenditure of funds, incurring of costs, or the use of any equipment or supplies by any person or any Federal, State, or local government agency, or any promise, agreement, or other arrangement by the person or agency to expend funds or use any equipment or supplies for the purpose of developing the information or performing the services described above. As an exception to this general rule, any funds paid for these purposes to an ANCSA corporation or to any subsidiary of such a corporation are not excludable under this provision.

The Act also provides that each ANCSA corporation is deemed to have become engaged in carrying on a trade or business as of the date it was incorporated for purposes of any form of Federal, State, or local taxation. Thus, a deduction for the ordinary and necessary business expenses of such a corporation will not be denied solely on the ground that they are "pre-opening" or "start-up" costs.

The Act provides that all expenses paid or incurred by an ANCSA corporation in connection with the selection or conveyance of lands pursuant to ANCSA, or in assisting another ANCSA corporation within or for the same region in the selection or conveyance of lands under ANCSA, are deemed to be ordinary and necessary expenses of the corporation, paid or incurred in carrying on a trade or business, for purposes of any form of Federal, State, or local taxation. As a result, these expenses generally will be deductible, whether they relate to land which is selected or land which is not selected.

Finally, the Act provides that no ANCSA corporation is to be considered to be a personal holding company.

***Effective date***

The provisions are generally effective as of December 18, 1971. The provisions relating to the exclusion from income of resource information and services apply to an ANCSA corporation after that date for a period of 20 years or until the corporation has received conveyance of its full land entitlement, whichever occurs first. The personal holding company provision applies until January 1, 1992.

***Revenue effect***

Because the questions resolved by the provision are in the early stages of litigation, it is not anticipated that the provision will affect budget receipts through 1983.

## **5. Replacement of Livestock With Other Farm Property Where There Has Been Environmental Contamination (sec. 542 of the Act and sec. 1033 of the Code)**

### ***Prior law***

The Code contains provisions under which taxpayers may elect not to recognize gain realized on the involuntary conversion of certain property if property similar or related in service or use to the property converted is acquired by the taxpayer within the replacement period (sec. 1033). In such a situation, gain is recognized only to the extent that the amount realized exceeds the cost of the replacement property. The basis of the replacement property is that of the converted property, decreased by any gain not recognized.

If livestock is involuntarily converted,<sup>1</sup> the "similar or related in service or use" requirement for nonrecognition can be satisfied only if the replacement property is livestock which is functionally the same as that converted.

### ***Reasons for change***

Congress believes that the requirement that involuntarily converted livestock be replaced by livestock used for the same purpose in order for nonrecognition treatment to be available is unnecessarily harsh in certain limited circumstances where reinvestment in such property is not feasible because of soil or environmental contamination. In such circumstances, Congress concluded that the tax law should not require reinvestment in such a limited class of property.

### ***Explanation of provision***

The Act provides for a broader class of qualifying replacement property in situations where livestock have been involuntarily converted because of soil contamination or other environmental contamination and, because of such contamination, it is not feasible for a taxpayer to reinvest the proceeds from involuntarily converted livestock in livestock similar or related in use to the converted livestock. In this situation, the taxpayer's reinvestment of such proceeds in other property (including real property) used for farming purposes will qualify for nonrecognition (or partial nonrecognition) under the involuntary conversion provisions.

### ***Effective date***

This provision applies to taxable years beginning after December 31, 1974.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million per year.

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<sup>1</sup> The destruction of livestock by or on account of disease, or the sale or exchange of livestock because of disease, is treated as an involuntary conversion (sec. 1033(d)).

## **6. Exclusion for Certain Cost-Sharing Payments (sec. 543 of the Act and new secs. 126 and 1255 of the Code)**

### ***Prior law***

Under prior law, government payments generally were included in the gross income of the recipient unless a specific exclusion was provided.

### ***Reasons for change***

There are a number of programs under which Federal and State governments make payments to taxpayers which represent a share of the cost of certain improvements made to land. In general, these programs relate to improvements which further conservation, protect or restore the environment, improve forests, or provide a habitat for wildlife. These payments ordinarily do not improve the income producing capability of the property. Also, since these payments represent a portion of an expenditure made by the taxpayer, the taxpayer generally does not have additional funds to pay the tax when such payments are made. The potential adverse tax consequences of the receipt of such payments may operate to discourage certain taxpayers from participating in these programs.

For these reasons, Congress believes that it is appropriate to exclude these payments from income and to provide for their inclusion only at the time the underlying property is disposed of.

### ***Explanation of provision***

The Act generally provides that gross income does not include the excludible portion of payments received under the following programs:

- (1) The rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act;
- (2) The rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977;
- (3) The water bank program authorized by the Water Bank Act;
- (4) The emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978;
- (5) The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act;
- (6) The great plains conservation program authorized by section 16 of the Soil Conservation and Domestic Policy Act;
- (7) The resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act;
- (8) The forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978;
- (9) Any small watershed program administered by the Secretary of Agriculture which is determined by the Secretary of the



Treasury to be substantially similar to the type of programs described in items (1) through (8); and

(10) Any State program under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

However, for a payment (or portion thereof) to be excluded from income under this provision, two conditions must be met. First, a determination must be made by the Secretary of Agriculture that the payment is made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife. Second, the Secretary of the Treasury must determine that the payment does not result in a substantial increase in the annual income derived from the property with respect to which the payment is made.

Neither a current deduction, depreciation, amortization, depletion, nor the investment credit may be claimed with respect to amounts excluded under this provision. The basis of any property acquired or improved with such payments would not reflect the amount of such payments. Recapture (that is, ordinary income treatment) is provided to the extent of the lesser of the income recognized or the excluded payments if the property or improvements purchased with such payments are disposed of before the expiration of 20 years. The amount recaptured is reduced 10 percent per year after the first ten years.

#### ***Effective date***

This provision applies to grants made after September 30, 1979.

#### ***Revenue effect***

This provision will not affect fiscal year 1979 budget receipts, but will reduce budget receipts by \$28 million in fiscal year 1980, and by \$79 million in fiscal year 1983.

## **E. TAX STUDIES**

### **1. Study of Simplification of Tax Returns (sec. 551 of the Act)**

#### ***Prior law***

Prior law did not require a specific study or report on tax simplification by the Treasury Department. However, the Tax Reform Act of 1976 required the Joint Committee on Taxation to conduct a study on simplifying the tax law. This study was completed and a report entitled "Issues in Simplification of the Income Tax Laws" was issued by the staff of the Joint Committee on Taxation on September 19, 1977.

#### ***Reasons for change***

The Congress believes that certain provisions of the Internal Revenue Code and certain filing requirements are complicated and create difficulty for many taxpayers in filing accurate returns. There also are provisions where complexity of the rules makes determination of a taxpayer's actual tax liability difficult.

#### ***Explanation of provisions***

The Act requires the Secretary of the Treasury to conduct a full and complete study and investigation with respect to: (1) provisions of the Internal Revenue Code which, due to their complexity, may hamper the ability of individuals to prepare accurate and complete Federal income tax returns, and (2) methods of simplifying income tax forms and instructions accompanying such forms.

The Secretary is to establish a task force to assist him in the study, which must report from time to time on its progress directly to the Secretary. The Secretary may appoint up to 10 employees to carry out the function of the task force.

The Secretary, after studying the reports and recommendations of the task force, must submit to the Senate Finance Committee and House Ways and Means Committee a final report on the study, together with such recommendations for legislation as he finds necessary, no later than November 6, 1980.

## **2. Study of the Tax Treatment of Certain Government-Mandated Expenditures (sec. 552 of the Act)**

### ***Prior law***

Under prior law there was no specific requirement that the Treasury Department conduct studies dealing with the appropriate income tax treatment of expenditures mandated by Government agencies.

### ***Reasons for change***

Expenditures mandated by the Occupational Safety and Health Administration (OSHA) or by the Mining Safety and Health Administration (MSHA) may place a significant financial burden on some taxpayers. In certain situations it may be appropriate to allow special tax treatment with respect to such expenditures. However, the Congress concluded that a number of technical and definitional problems will have to be resolved before any special tax treatment can be considered, and that further study of the issues involved is needed.

### ***Explanation of provision***

Under the Act, the Treasury Department is required to conduct a study with respect to the tax treatment of expenditures incurred in compliance with OSHA and MSHA. The study is to include the feasibility of providing 5-year amortization as well as special investment tax credit provisions.

The Treasury Department is to report to the Congress before April 1, 1979.

### **3. Study of Taxation of Nonresident Alien Real Estate Transactions in the United States (sec. 553 of the Act)**

#### ***Prior law***

Under the Code, nonresident aliens and foreign corporations, not actively engaged in the real estate business in the United States, are subject to a flat 30-percent tax on their gross current income from U.S. real estate investments, but they are ordinarily exempt from capital gains tax on the sale of capital assets, including U.S. real estate. They may elect, however, to be taxed on a net basis on their current income from real estate in the same manner as U.S. persons but, as a condition, must agree to be taxable on any gains from the sale of that real estate.

Foreign investors can generally avoid most or all U.S. taxes on U.S. real estate by utilizing U.S. tax treaties. If, for example, a foreign investor makes a U.S. real estate investment using a Netherlands Antilles holding company, the election to be taxed on a net basis can be made annually under the tax treaty applicable to the Netherlands Antilles. Particularly in situations where the real estate investment is financed in part with debt, it is generally possible to structure the investment so that it does not yield taxable income on a current basis. (The funds may even be lent to the holding company by the foreign investors themselves, and the interest payments would be deductible for U.S. tax purposes by the holding company but the foreign investors may be exempt from U.S. tax under the treaty on the interest they receive. *Cf.* Rev. Rul. 75-23, 1975-1 C.B. 290.) In the year the U.S. real estate is sold, the foreign investor does not make the annual election and the gain on the sale is exempt from U.S. tax under the normal Code rule for foreign investors.

#### ***Reasons for change***

The Congress concluded that it was necessary to review the application of U.S. tax laws and treaties to foreign investors in U.S. property to determine whether the present relatively favorable tax treatment afforded foreign investors should be modified.

#### ***Explanation of provision***

The Act directs the Treasury Department to submit to Congress a study on the taxation of foreign owners of interests in U.S. property for the purpose of determining the appropriate treatment of the income or gain from these assets. The study is to be completed within six months of the date of enactment (by May 6, 1979).

#### **4. Report on Effectiveness of Jobs Credit (sec. 554 of the Act)**

##### ***Prior law***

Prior law contained no requirement that the Secretary of the Treasury report on the effectiveness of the general jobs credit.

##### ***Reasons for change***

The Congress is concerned with what effect the new targeted jobs credit will have on the hiring of employees who are members of groups that the Congress believes are deserving of special consideration and believes that this matter should be thoroughly investigated. The Congress also is concerned with determining the effectiveness of the prior general jobs credit in stimulating employment and enhancing economic growth.

##### ***Explanation of provision***

The Act requires the Secretaries of Labor and Treasury jointly to submit a report to the Senate Finance Committee and House Ways and Means Committee on: (1) the effectiveness of the targeted jobs credit in improving the employment situation of the targeted groups, and (2) the types of employees claiming the credit. This report also is to include an evaluation of: (1) the effectiveness of the general jobs credit for 1977 and 1978 in stimulating employment and enhancing economic growth, and (2) the types of employers claiming the credit.

In addition, the report is to include an evaluation of the probable effectiveness and feasibility of any alternatives to a jobs credit. This portion of the report is to include an evaluation of the probable economic effect and feasibility of a tax credit based on increases in worker opportunity. The evaluation should include consideration of a credit of up to 10 percent of certain wage levels with a provision for disqualification or credit phase-out if the worker is employed by a company which raises its prices above certain levels during a year.

This report is due no later than June 30, 1981.

## **5. Study of Effects of Capital Gains Tax Changes (sec. 555 of the Act)**

### ***Prior law***

Under prior law, the Treasury Department generally was not required to submit reports to Congress on the effectiveness of specific tax provisions.

### ***Reasons for change***

Due to the economic importance of capital formation and employment growth, the Congress believes that it is appropriate to have a study conducted on the impact of the reduction of individual and corporate capital gains tax rates on these areas.

### ***Explanation of provision***

The Act requires the Treasury Department to prepare, and submit to Congress, a report on the effectiveness of the reductions of both the individual and corporate capital gains tax rates in stimulating investments, increasing the rate of economic growth, increasing employment, and of the effects of these reductions on income tax revenues. The report is to be made by September 30, 1981.

## **TITLE VI—GENERAL STOCK OWNERSHIP CORPORATIONS**

### **6. Tax Treatment of General Stock Ownership Corporations and Their Stockholders (sec. 601 of the Act and secs. 1391–1397, 172(b), 3402(r), 1016(a), and 6039B of the Code)**

#### ***Prior law***

Under prior law, there were no special provisions relating to the establishment of a private corporation for the benefit of the residents of a State.

#### ***Reasons for change***

The Congress believed that many citizens should have a greater ownership stake in the private enterprise system which would lead to a better citizen understanding of the system and would encourage individuals to invest in other business enterprises. Also, in the case of individuals now receiving various forms of transfer payments from Federal, State, or local governments, the receipt of dividend income from a General Stock Ownership Corporation (GSOC) would, to some extent, reduce the need for such payments. The Congress concluded that an experimental program permitting States to form such private corporations for the benefit of all their citizens would enable the Congress to study a method of replacing transfer payments with dividend income.

#### ***Explanation of provision***

##### ***General***

The Act authorizes a State to establish a General Stock Ownership Corporation (GSOC) for the benefit of all its citizens. It is anticipated that the GSOC will be permitted to borrow money to invest in business enterprises. The cash flow from the operation of the business would be used to service and repay the loan, and the remaining cash would be distributed to the GSOC shareholders (i.e., all the citizens of the State).

##### ***Definition of GSOC***

The Act provides that a corporation must meet certain statutory tests in order to be treated as a GSOC. First, the corporation must be chartered by an official act of the State legislature or by a State-wide referendum. Second, the GSOC's corporate charter must provide for the issuance of only one class of stock, the issuance of shares only to eligible individuals and the issuance of at least one share to each eligible individual if such eligible individual does not elect within one year after the date of issuance not to receive such share. The Act also requires the charter to provide for certain restrictions on the transferability of the GSOC shares. The transfer restriction must provide that the share cannot be transferred until the earliest to occur of (1) the

expiration of 5 years from issuance, (2) death, or (3) failure to meet the State's residency requirements. In no event may shares of stock of a GSOC be transferred to nonresidents. Also, no person may acquire more than 10 shares of the GSOC's stock. Third, the GSOC must not be empowered to invest in properties acquired by it or for its benefit through the right of eminent domain. Fourth, the GSOC may not be affiliated with any other corporation. For this purpose, a 20 percent ownership test will apply to determine affiliated status rather than the customary 80 percent test. Fifth, the GSOC must be organized after December 31, 1978, and before January 1, 1984.

An eligible individual is any individual who is a resident of the chartering State as of the date specified in the enabling legislation and who remains a resident between that date and the date of issuance of the stock. A State may define a resident for purposes of its GSOC so long as such definition is consistent with constitutional principles.

### *Election by GSOC*

A GSOC must make an election to obtain the special statutory treatment provided for by the amendment. The election is effective for the taxable year for which it is made. The manner in which the election is to be made is to be determined by regulations promulgated by the Department of the Treasury. The election once made is irrevocable unless terminated with the consent of the Secretary of the Treasury. In addition, the election is terminated if the corporation ceases to qualify as a GSOC.

The effect of the election is to exempt the corporation from Federal income taxation. Instead, the shareholders of the GSOC would report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

### *Other rules for GSOC*

*Treated as a private corporation.*—A GSOC is treated as a private corporation for Federal income tax purposes.

*Computation of GSOC income.*—The GSOC computes its taxable income in the same manner as a regular corporation with certain modifications. The GSOC is not eligible for a dividends received deduction nor any tax credit.

*Net operating loss deduction.*—The shareholders of a GSOC are not eligible to report any portion of a GSOC net operating loss on their individual income tax returns. Instead, the GSOC is entitled to a 10-year carryover of any net operating loss.

*Investment tax credit and recapture of investment tax credit.*—Under the Act, shareholders of the GSOC are entitled to their pro-rata share of the GSOC's investment tax credit. The shareholders are also personally responsible for any recapture of the investment tax credit. Neither the corporation nor its shareholders is entitled to the foreign tax credit.

*Distribution requirements.*—A GSOC is required to distribute 90 percent of its taxable income for any taxable year to its shareholders by January 31 of the next succeeding year. To the extent a GSOC fails to meet this distribution requirement, a tax equal to 20 percent of the deficiency (i.e., the difference between the required distribution and the actual distribution) is imposed on the GSOC. The amount



of such tax will be allowed as a deduction to the GSOC for the year in which it is paid rather than the year of accrual.

*Taxation of GSOC shareholders*

Under the Act, each shareholder includes in his gross income his daily pro rata portion of the GSOC's taxable income. Such income is included in the shareholder's gross income for the taxable year in which or with which the GSOC's taxable year ends. The income in the hands of the shareholder is treated as ordinary income and is not eligible for the partial dividend exclusion (sec. 116).

Shareholders will increase the tax basis of shares of stock in the GSOC by the amount of the GSOC taxable income which is taxed to the shareholders. This basis adjustment is made by a shareholder only to the extent an amount is actually included in gross income in his or her income tax return (unless under section 6012(a)(1), the shareholder is not required to file a return). Distribution from the GSOC out of such previously taxed income decreases the tax basis of such shares.

*Taxation of GSOC distribution.*—Under the Act, distributions from a GSOC's income which have been previously taxed to a shareholder are treated as tax-free distributions. Any distribution in excess of such previously taxed income is taxed to the shareholders in the same manner as a distribution from a regular corporation (sec. 301 (c)).

*Audit adjustments and amended tax returns.*—Any audit adjustment resulting from an Internal Revenue Service determination is to be reflected in the GSOC's taxable year in which such adjustment is made (and not the taxable year to which it relates). The amount of such adjustment is subject to an interest charge in an amount computed as though the income had been taxed to a nonelecting regular corporation.

*Reporting requirements.*—Under the Act, a GSOC is required to file a Federal income tax return and appropriate data showing information reported to each of its shareholders. The GSOC's tax return is required to meet the same filing requirements as a regular corporation. In addition, a GSOC is required to give each shareholder an annual receipt or statement. If required by the Treasury Department, the annual receipt or statement will show (1) the shareholder's pro rata income for the taxable year, (2) tax-free distributions for the year, (3) the tax treatment of other distributions, (4) the amount of any investment tax credit and recapture thereof for such year, and (5) any amounts withheld for Federal income tax purposes.

*Withholding requirements.*—The Act requires the GSOC to withhold an amount equal to 25 percent of every distribution made to each of its shareholders. The amount withheld is allowed as a refundable credit to the shareholders. The Treasury is authorized to issue regulations providing a certification procedure for individuals who are non-taxpayers under which they may be exempted from the withholding requirement.

*Taxable year of GSOC.*—The Act requires all GSOCs to adopt a taxable year ending on October 31 unless the Secretary of the Treasury consents to a different year end. This will enable them to close their books and meet their shareholder reporting requirements by January 31 of the next succeeding year.

*Studies*

The Act also requires the staff of the Joint Committee on Taxation to prepare a report on the operation and effect of any electing GSOCs. **An interim report is to be filed within two years after the first GSOC is formed and a final report is due by September 30, 1983.**

***Effective date***

The provision applies to corporations chartered and organized after December 31, 1978.

***Revenue effect***

The revenue cost of the proposal is expected to be negligible during the next few years. However, the long-run cost could be substantial.

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## **TITLE VII—TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1976<sup>1</sup>**

### **A. AMENDMENTS TO INCOME TAX AND ADMINISTRATIVE PROVISIONS**

#### **1. Retirement Income Credit for Public Retirees Under Age 65 (sec. 701(a) of the Act and sec. 37 of the Code)**

##### ***Prior law***

Prior to the enactment of the 1976 Tax Reform Act, the retirement income credit was generally 15 percent of the first \$1,524 of retirement income for each eligible individual age 65 and over, or 15 percent of the first \$2,286 of retirement income for electing married couples with only one eligible spouse. Special rules provided that a taxpayer under age 65 was eligible for a retirement income credit with respect to pensions received from a Federal, State, or local government retirement system.

The 1976 Act increased the maximum credit base to \$2,500 (\$3,750 for joint returns if each spouse is eligible for the credit), renamed the general provision the credit for the elderly, simplified the qualification requirements, and broadened the category of eligible individual age 65 and over. Although the credit for public retirees under age 65 was also simplified and increased, most of the prior law provisions for public retirees under age 65 were retained. However, the requirement that an individual have earnings of at least \$600 for 10 years was eliminated.

##### ***Reasons for change***

As a result of changes made by the 1976 Act, several unforeseen problems have developed with regard to the special retirement income credit for public retirees under age 65. The laws of community property States require equal splitting of community income, including items such as earnings, pensions, and social security benefits, which are taken into account for purposes of this credit. Consequently, these laws affect both the determination of eligibility for the credit and the computation of the credit. Thus, the amount of the credit varies depending upon whether the retiree lives in a community property State or in a common law State.

In addition, the credit has been claimed by married couples with one spouse a public retiree age 65 or older and the other spouse a nonpublic retiree under age 65. This unintended situation resulted by oversight from the lack of an explicit statutory requirement that the spouse who is under age 65 be the one receiving the public retirement system income.

<sup>1</sup> In general, these provisions were contained in a separate bill, H.R. 6715, passed by the House and reported by the Senate Finance Committee. Except for several changes incorporated in the Senate amendment to the Revenue Act of 1978, the relevant legislative history is contained in House Report No. 95-700 and Senate Report No. 95-1263.

Furthermore, because the Tax Reform Act of 1976 eliminated the 10-years' earnings test and because "retirement income" eligible for the credit continued to be defined as income from public retirement system pensions and annuities received by an individual under age 65, the credit has been claimed by taxpayers who receive such income but who are neither public retirees nor spouses of public retirees and who were not intended to qualify for the credit. For example, some public retirees' children who receive public retirement system income because of their parents' death have claimed the credit.

The Congress believes that the situations described above are inconsistent with the Congressional intent regarding the revisions of the retirement income credit rules in the Tax Reform Act of 1976. The Congress therefore has decided to eliminate the difference in the tax treatment of married public retirees in community property and common law States who file joint returns, to clarify the special rules for married public retirees with one spouse under age 65 and the other spouse age 65 or over, and to limit the credit explicitly and exclusively to public retirees and their spouses.

### ***Explanation of provision***

Under the Act, the community property rules are to be disregarded in determining eligibility for the special retirement income credit and in computing the credit for public retirees and their spouses who file joint returns.<sup>1</sup> The Act also specifies that, in order for a married couple to claim the credit, the spouse under age 65 must receive public retirement income. In addition, the Act makes it clear that an individual under age 65 may qualify for this credit only if that individual or the spouse of that individual actually performed the services covered by a public retirement system.

### ***Effective date***

These provisions clarifying the eligibility rules limiting the credit to public retirees under age 65 and their spouses apply to taxable years beginning after December 31, 1975. The elimination of the difference in tax treatment resulting from differences in State laws applies to taxable years beginning after December 31, 1977.

### ***Revenue effect***

This provision will increase tax receipts by less than \$1 million per year.

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<sup>1</sup> The community property rules are to be observed in the case of married couples filing separate returns (who must live apart for the entire taxable year in order to do so and also claim the credit). They are to apply in order to avoid the confusion that would result from requiring two sets of calculations, one for the computation of tax and the other for the computation of the credit, and the inequity which would result in such case if an individual were taxed on his or her share of community retirement income without being able to claim any retirement income credit on that income.

## **2. Amendments Relating to the Minimum Tax**

### ***a. Subchapter S corporations and personal holding companies (sec. 701(b)(1) of the Act and sec. 57 of the Code)***

#### ***Prior law***

Under the minimum tax provisions, electing small business corporations (subchapter S corporations) and personal holding companies generally determine their tax preferences in a manner similar to individuals. The 1976 Act added a new preference for individuals with adjusted itemized deductions, i.e., certain itemized deductions in excess of 60 percent of adjusted gross income.

#### ***Reasons for change***

The Congress believes it appropriate to clarify the minimum tax provisions in the case of small business corporations and personal holding companies.

#### ***Explanation of provision***

The Act clarifies that the preference for adjusted itemized deductions (sec. 57(a)(1)) does not apply to subchapter S corporations and personal holding companies since these corporations have no adjusted gross income from which to calculate this preference.

#### ***Effective date***

The amendments made by this section apply to items of tax preference for taxable years beginning after December 31, 1975.

#### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

### ***b. Exemption for controlled groups for purposes of the minimum tax (sec. 701(b)(2) of the Act and sec. 58 of the Code)***

#### ***Prior law***

Under prior law, in the case of a controlled group of corporations, the group's \$10,000 amount used in computing the minimum tax exemption was allocated among the members of the group equally or according to a plan adopted by the members of the group.

#### ***Reasons for change***

The 1976 Act changed the exemption for the minimum tax on corporations to the greater of \$10,000 or their regular tax deduction, but did not change the manner in which the exemption could be apportioned in the case of a controlled group. Consequently, a taxpayer may be able to allocate the \$10,000 amount to relatively low tax-paying members in order for the group to obtain a total exemption in excess of the exemption which the group would have if it were a single corporation.

***Explanation of provision***

The Act requires the allocation of the \$10,000 exemption amount to each of the members of a controlled group in proportion to each member's regular tax deduction.

***Effective date***

This provision is generally effective for taxable years beginning after December 31, 1975.

***Revenue effect***

This provision will increase budget receipts by less than \$1 million per year.

***c. Minimum tax imposed on trusts and estates (secs. 701(b)(3) and (4) of the Act and sec. 57 of the Code)***

***Prior law***

The 1976 Act created a new preference for adjusted itemized deductions to the extent they exceed 60 percent of adjusted gross income for purposes of the minimum tax. Generally, the Act included charitable deductions that are included as itemized deductions of trusts and estates for purposes of determining if there are "excess" itemized deductions treated as a preference under the minimum tax.

***Reasons for change***

The Congress believes that the law should be clarified to insure that the concept of "adjusted gross income" applies to a trust or estate for purposes of the minimum tax in the same manner as to an individual. Moreover, the Congress believes that the personal exemption of an estate or trust should not be treated as an itemized deduction.

Moreover, the charitable deduction, generally, is treated as an itemized deduction even though imposition of the minimum tax may actually reduce the amount passing to charity and even though the trust was not established to avoid the application of the minimum tax to the grantor since it was created prior to the 1976 Act.

Consequently, the Congress believes that the charitable deduction should not be treated as an itemized deduction in the case of deductions attributable to transfers in trust made before the effective date of the adjusted itemized deduction preference. In addition, the Congress believes that the charitable deduction should not be treated as an itemized deduction for minimum tax purposes where the remainder interest has been given to charity.

Finally, the Congress believes that the deduction for estate taxes attributable to income in respect of a decedent should not be treated as an itemized deduction for individuals or for trusts and estates.

***Explanation of provision***

The Act clarifies in several respects the treatment of trusts and estates under the minimum tax in the case of the preference for adjusted itemized deductions. First, the Act makes it clear that the concept of "adjusted gross income" applies to trusts and estates in basically the same manner as to individuals. Second, the Act clarifies that the personal exemption (under sec. 642(b)) is not taken into account in determining the adjusted itemized deductions of a trust or estate. Third, the Act provides that the deduction for administration expenses and, in the case of estates, wholly charitable trusts, testamentary charitable lead trusts, transfers in trust before January 1, 1977, and pooled income funds,<sup>1</sup> the deductions for charitable contributions are treated as deductions in determining adjusted gross income. For this purpose, a transfer to a trust after January 1, 1977, from an estate of a decedent dying before that date shall be treated as a transfer in trust before January 1, 1977.

Finally, the Act provides that the deduction for estate taxes attributable to income in respect to a decedent is not taken into account in

<sup>1</sup> Charitable remainder trusts (sec. 664) created after the Tax Reform Act of 1969 are generally exempt from both the income tax and the minimum tax and, consequently, no exception is necessary for these trusts.

computing the preference for adjusted itemized deductions for individuals or for trusts and estates.

***Effective date***

The amendments made by this section are effective as if they had been incorporated in the Tax Reform Act of 1976. However, for taxable years beginning after December 31, 1978, additional changes are made to the preference for adjusted itemized deductions by section 421 of this Act.

***Revenue effect***

This provision will affect budget receipts by less than \$1 million per year.

### **3. Exclusion For Disability Income (sec. 701(c) of the Act and sec. 105 of the Code)**

#### ***Prior law***

Under prior law, as amended by the Tax Reform Act of 1976, the exclusion for disability income (the "sick pay" exclusion) was limited to a maximum of \$5,200 a year per taxpayer. The sick pay exclusion was phased out based on the adjusted gross income of the taxpayer in excess of \$15,000. Married couples claiming the sick pay exclusion were required to file joint returns.

#### ***Reasons for change***

The legislative history of the 1976 Act indicates that in the case of joint returns, a maximum exclusion of \$5,200 would be available for each spouse but that the \$15,000 income limitation would apply to total income shown on the joint return.

Because the statute uses the term "taxpayer" to mean the individual taxpayer in one instance and the married couple in another, it is not clear whether the income phaseout is to be made separately on the basis of each spouse's adjusted gross income or on their combined income. Nor is it entirely clear whether, if otherwise eligible, both spouses are entitled to one of two maximum exclusions of \$5,200. The Congress believes that the application of these provisions should be clarified.

#### ***Explanation of provision***

To eliminate any ambiguity, the sick pay exclusion is restructured to specify that the \$5,200 maximum exclusion is to be applied separately to each spouse and that the \$15,000 adjusted gross income limit is to be applied to their combined adjusted gross income.

#### ***Effective date***

This provision applies to taxable years beginning after December 31, 1975.

#### ***Revenue effect***

This provision has no effect on budget receipts.

#### **4. Net Operating Loss Carryback and Carryforward (sec. 701(d) of the Act and sec. 172 of the Code)**

##### ***Prior law***

Prior law provided varying periods for the carryback and carryforward of net operating losses by different categories of taxpayers. For taxpayers in general, the law prior to the Tax Reform Act of 1976 allowed net operating losses to be carried back for 3 years and forward for 5 years. (A similar rule applied to insurance companies.) Regulated transportation companies were previously allowed to carry net operating losses back for 3 years and forward for 7 years.

The 1976 Act increased the loss carryforward period by two years for those categories of business taxpayers. The two additional carryforward years were not provided, however, for categories of taxpayers which were already allowed extended loss carryback or carryover periods, such as financial institutions (which have 10-year loss carrybacks and 5-year carryforwards).

##### ***Reasons for change***

The provisions of the 1976 Act inadvertently extended two additional carryover years to Banks for Cooperatives which, like other financial institutions, were already allowed 10-years loss carryback and 5-year loss carryforward periods.

##### ***Explanation of provision***

The provision corrects this oversight and eliminates Banks for Cooperatives from the categories of taxpayers which are eligible for the two additional loss carryforward years under the Tax Reform Act of 1976.

##### ***Effective date***

This amendment is effective for losses incurred in taxable years ending after December 31, 1975.

##### ***Revenue effect***

This provision has no effect on budget receipts.



## **5. Construction Period Interest and Taxes (sec. 701(e) of the Act and sec. 189 of the Code)**

### ***Prior law***

The 1976 Act added a new provision (sec. 189) requiring the capitalization and amortization of real property construction period interest and taxes by individuals, subchapter S corporations, and personal holding companies. In the case of nonresidential real property, the new provisions apply where the construction period begins after December 31, 1975. However, no provision for an amortization deduction was provided with respect to construction beginning in 1976 where the taxpayer's taxable year began in 1975.

### ***Reasons for change***

The Congress believes it necessary to clarify that capitalization and amortization of construction period interest and taxes for nonresidential real property is required only if the construction period begins on or after the first day of the first taxable year beginning after December 31, 1975.

### ***Explanation of provision***

The Act clarifies that capitalization and amortization of construction period interest and taxes for nonresidential real property is required only if the construction period begins on or after the first day of the first taxable year beginning after December 31, 1975.

### ***Effective date***

This provision is effective on the date of enactment of the Act.

### ***Revenue effect***

This provision will reduce budget receipts in fiscal year 1978 by less than \$1 million.

## **6. Tax Treatment of Certified Historic Structures (sec. 701(f) of the Act and secs. 167, 191, and 280B of the Code)**

### ***Prior law***

Under the 1976 Act, taxpayers are allowed to amortize over 5 years the expenses incurred in rehabilitating certified historic structures or, alternatively, to depreciate substantially rehabilitated historic structures using accelerated depreciation methods. The 1976 Act also prohibits deductions with respect to the demolition of certified historic structures and requires straight-line depreciation of any replacement structure.

Under the Act, a certified historic structure is defined as a depreciable structure listed in the National Register, a depreciable structure located in a district listed in the National Register if the Secretary of the Interior certifies that the structure is of historic significance to the district, or a depreciable structure located in a State or locally designated historic district which meets certain tests.

The 1976 Act provides that the full amount of the rapid amortization deductions claimed are to be recaptured on the sale or exchange of an historic structure (i.e., gain on the disposition, to the extent of the rapid amortization claimed, is treated as ordinary income rather than capital gain).

### ***Reasons for change***

Because of the differences in the requirements for qualifying as a certified historic structure in the case of buildings located in Federally designated historic districts and State or locally designated historic districts, the tax treatment of a building under the 1976 Act depends upon the type of historic district it is located in. The Congress believes that several modifications to the provisions dealing with historic structures are necessary to eliminate these unintended differences and establish more equivalent treatment for all types of historic districts and structures.

Recapture of the full amount of the rapid amortization deductions claimed with respect to expenditures for rehabilitating historic structures (as required by the 1976 Act) is the recapture rule that generally applies with respect to recapture of depreciation or amortization deductions on dispositions of personal property. In the case of real property, recapture is ordinarily limited to the extent that the depreciation or amortization deductions claimed exceed otherwise allowable straight-line depreciation. The Congress believes it is appropriate to conform the recapture rules applicable to amortization of rehabilitation expenses of historic structures with the rules applicable to real estate generally.

### ***Explanation of provision***

Under the definition contained in the 1976 Act, there is no requirement that State or locally designated districts satisfy the criteria for listing on the National Register or that structures be of historic sig-

nificance to the districts. The 1978 Act conforms the definition with respect to structures located in State or locally designated districts with the rules applicable to Federally designated districts by providing that structures in these districts are certified historic structures only where the district substantially satisfies the criteria for listing in the National Register and the Secretary of the Interior certifies that the structure is of historic significance to the district.

It is the current policy of the Department of the Interior, and the Congress' intent, that buildings within registered historic districts can be certified as significant if they contribute to the significance of the district as a whole even if they do not individually qualify for listing in the National Register. For example, a turn of the century warehouse in a district identified for its significance in the commercial development of a city might be certified as contributing to the significance of the district based on the history of architecture of the structure and the area in which it is located.

The 1976 Act contains a special rule under which deductions are not allowed with respect to the demolition of a structure located in a registered historic district unless the Secretary of Interior certifies that the building is not of historic significance. The 1978 Act applies this special rule to structures located in State or locally designated districts. The Act also provides that, in order to obtain accelerated depreciation on a structure replacing a demolished structure which was located in a Federal, State, or locally designated historic district, certification that the structure to be demolished is not historically significant must be obtained prior to its demolition unless the taxpayer, in good faith, was not aware of the certification requirement at the beginning of the demolition.

The 1978 Act applies the real property recapture rules to rapid amortization deductions claimed with respect to rehabilitations of certified historic structures. Thus, recapture is limited to the excess of the amortization claimed over the otherwise allowable straight-line depreciation (computed on the basis of the actual useful life). The Act makes it clear that the excess amortization claimed over the otherwise allowable straight-line depreciation is a preference for minimum tax purposes (as is the case with other excess depreciation on real property).

In addition, the 1978 Act clarifies other 1976 Act law provisions dealing with historic structures. Under the 1976 Act, a taxpayer could elect either rapid amortization or accelerated depreciation with respect to the same substantial rehabilitation of a certified historic structure, but he could not elect both (i.e., the taxpayer could not claim rapid amortization with respect to the amounts spent on rehabilitation and claim accelerated depreciation with respect to the remaining basis of the property). The 1978 Act makes it clear that a taxpayer may not elect accelerated depreciation (under sec. 167(o)) on a substantially rehabilitated historic structure if he has previously elected rapid amortization of rehabilitation expenditures with respect to that building. The Act also makes it clear that the required use of straight-line depreciation with respect to a structure which has been substantially altered (other than by a certified rehabilitation) does not apply where there is a subsequent substantial alteration of the structure which is a certified rehabilitation.

The 1978 Act permits lessees of historic structures to claim the rapid amortization deductions with respect to expenditures incurred in rehabilitating certified historic structures in situations where the lessee holds the historic structure under a lease which, at the time the improvements are completed, has a remaining term at least as long as the useful life of the improvements determined without regard to any renewal periods (but in no event less than 30 years). As in the case of dispositions by owners of historic structures claiming the benefit of the 1976 Act provisions, benefits claimed by lessees under this proposal would be subject to recapture if the lease is terminated early.

***Effective date***

The provisions with respect to historic structures take effect as if they were included in the provisions of the Code to which they relate, as those provisions were added by the Tax Reform Act of 1976.

***Revenue effect***

This provision will reduce budget receipts by less than \$2 million per year.

## **7. Deduction for Attending Foreign Conventions (sec. 701(g) of the Act and sec. 274(h) of the Code)**

### ***Prior law***

Prior to the 1976 Act, a deduction was allowed for traveling expenses paid or incurred to attend a foreign convention if the traveling expenses were reasonable and necessary in the conduct of the taxpayer's business and directly attributable to the trade or business. The lack of specific detailed requirements created substantial administrative problems for the IRS.

The 1976 Act provided specific rules (sec. 274(h) of the Code) limiting the deduction for expenses of attending conventions, seminars or similar meetings held outside the United States, its possessions, and the Trust Territory of the Pacific. These rules apply not only to the individual attending the convention, but also to his employer, if the employer pays the expenses. The new rules apply to conventions beginning after December 31, 1976. Under the new rules:

1. No deduction is allowed for expenses paid or incurred by an individual in attending more than two foreign conventions in any taxable year.

2. With respect to the two conventions for which a deduction is allowable, the amount of expenses that can be deducted for transportation and subsistence are limited. A deduction for transportation expenses outside the United States may not exceed coach or economy rates charged by a commercial airline. The deduction for subsistence may not exceed the dollar per diem rate established for federal employees at the location in which the convention is held.

3. No deduction is allowed for subsistence expenses unless (a) a full day or half day of business activities are scheduled on each day during the convention, and (b) the individual attends at least two-thirds of the hours of the daily scheduled business activities or, in the aggregate, attends at least two-thirds of the total hours of scheduled business activities at the convention.

4. The taxpayer must comply with additional reporting requirements. He must furnish information indicating the total days of the trip (exclusive of the transportation days to and from the convention), the number of hours of each day that he devoted to business activities (in a brochure describing the convention, if available), and any other information required by regulations. In addition, the taxpayer must attach a statement to his income tax return signed by an appropriate officer of the sponsoring organization which must include a schedule of the business activities of each convention day, the number of hourly-related activities that the taxpayer attended each day and any other information required by regulations.

5. A deduction for the full expenses of transportation (subject to the coach or economy rate limitation) to and from the site of a foreign convention will be allowable only if one-half or more of the total days

of the trips are devoted to business-related activities. The same rules for counting full days and half-days for purposes of subsistence expenses are applied.

### ***Reasons for change***

The Congress believes that it is not necessary to apply the rules described above to limit the deduction otherwise available to an employer who pays the expenses of an employee to attend a foreign convention where those payments are includible in the employee's income.

### ***Explanation of provision***

#### ***Amounts includible in income***

The Act provides that the limitations added by the Tax Reform Act of 1976 on the deductibility of attending foreign conventions do not apply to an employer (or other person) paying the expenses of an individual attending a foreign convention (either directly or through reimbursement) where that individual is required to include the expenses in his gross income. This exception would not apply to a payor where the amounts paid are required to be furnished by the payor to the payee on information returns or statements (i.e., Form W-2 or Form 1099) but are not furnished by the payor.

For example, where a manufacturer purchases tickets for the attendance by one or more of the employees of its dealers at a foreign convention as an incentive award and transfers the tickets to its dealers who in turn award them to certain employees, the manufacturer will not be subject to these limitations if the tickets are includible in income of the dealer and the manufacturer complies with any required information reporting. Further, the limitations will not apply to the dealer for any amount if the employee is required to include that amount in his income and the dealer complies with the applicable information reporting requirements. Of course, the rules described above limiting deductions for foreign conventions continue to apply to the individual involved to determine the extent to which he is entitled to deduct the convention expenses.

#### ***Business activities allocation rule***

The 1976 Act added new provisions limiting the deduction for attendance at a foreign convention. One of the provisions limits the deductibility of the full transportation expenses to and from the site of the convention to situations where "more than one-half" of the total days of the trip (exclusive of days travelling to and from the convention) are devoted to business activities. If "less than one-half" of the total days are devoted to business activities, the transportation expenses are allocated to business activities on the basis of the percentage of days devoted to business. No specific rule is prescribed when exactly one-half of the time is devoted to business.

To correct this situation, the Act makes it clear that a portion of the transportation expenses will be denied only where less than one-half of the total days are devoted to business activities.

#### ***Individuals residing in foreign countries***

The Act also provides that the attendance by a U.S. citizen who is a bona fide resident of a foreign country at a convention in that foreign country will not be treated as attendance at a foreign convention.

***Effective date***

These provisions are effective for conventions beginning after December 31, 1976.

***Revenue effect***

These provisions will have no effect on budget receipts.

## **8. Deduction for Expenses Attributable to Rental of Vacation Homes (sec. 701(h) of the Act and sec. 280A of the Code)**

### ***Prior law***

Prior to the 1976 Act, a taxpayer was allowed a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, or for the management, conservation, or maintenance of property held for the production of income. For a deduction to be allowable under these provisions, the activity must have been engaged in by the taxpayer for the purpose of or with the intention of making a profit. The determination of whether an activity was engaged in for profit was made on the basis of objective standards, taking into account all facts and circumstances of each case. However, in the case of residential property held for both business and personal purposes, no definitive rules were provided to determine which expenses were attributable to the business use of the property.

The 1976 Act added a provision which, in general, provides a limitation on the amount allowable to a taxpayer for the deductions attributable to the rental of a dwelling unit if the taxpayer personally uses the unit in excess of specified periods of time during a taxable year. This new limitation applies if the taxpayer's use of the dwelling unit for personal purposes during his taxable year exceeds the greater of 14 days or 10 percent of the number of the days during the year for which the home is rented. The purpose of this limitation was to prevent the conversion of nondeductible personal living expenses into deductible expenses.

### ***Reasons for change***

The Congress does not believe that the personal use of a principal residence for a portion of the taxable year should result in the disallowance of deductions for the period when the residence has been converted to rental property.

### ***Explanation of provision***

The Act provides that the use of a dwelling unit as a taxpayer's principal residence (within the meaning of section 1034) is not to be treated as personal use for purposes of determining whether the deductions attributable to a "qualified rental period" are subject to the limitations added by the 1976 Act. For this purpose, a "qualified rental period" will be a consecutive period of 12 months or more, beginning or ending during the taxable year, during which the unit is rented (other than to a brother, sister, spouse, ancestor or lineal descendant of the taxpayer), or held for rental, at its fair market rental. The 12-month rental requirement does not apply if the residence is sold or exchanged before it has been rented, or held for rental, for the full 12 months.



The provision does not apply to the deductions attributable to any period other than the "qualified rental period". In addition, the provision does not affect the allocation of deductions attributable to the rental period.

The determination of whether a unit is a principal residence (within the meaning of section 1034) is to depend on the facts and circumstances of each particular case.

***Effective date***

The provision applies to taxable years ending after December 31, 1975.

***Revenue effect***

This provision will have a negligible effect on budget receipts.

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## **9. Simultaneous Liquidation of Parent and Subsidiary Corporations (sec. 701(i) of the Act and sec. 337 of the Code)**

### ***Prior law***

Under present law, if a corporation adopts a plan of complete liquidation and within 12 months thereafter distributes to its shareholders all of its assets (less those retained to meet claims), gain or loss is generally not recognized to the corporation for tax purposes with respect to property it sold during the 12-month period (sec. 337). The purpose of this provision is to provide the same tax treatment (a single tax at the shareholder level) where a corporation sells its properties and then distributes the proceeds to its shareholders as that which would be provided had the corporation first distributed the properties in kind to the shareholders who then sold the property.

Section 337 generally does not apply to a sale of assets by an 80 percent or greater controlled subsidiary which liquidates into its parent corporation. In that case, the parent corporation is not taxable on the liquidation of the subsidiary (sec. 332), and no current tax would be imposed at all if sections 332 and 337 were available at the same time.

As amended by the 1976 Act, the rule for 12-month liquidations under section 337 is available for a sale by a member of an affiliated group of corporations if every other member of the group which receives a liquidating distribution also liquidates completely.

### ***Reasons for change***

The 1976 Act did not make the new rule inapplicable to those situations where the parent (or common parent) corporation is liquidated tax-free (in whole or in part) under the one-month liquidation rule of section 333 of the Code. (Under section 333, a shareholder's gain is taxable only to the extent the corporation has accumulated earnings and profits or distributes money and stocks or securities acquired after 1953.) If both liquidation provisions (secs. 333 and 337) could apply to an asset sale followed by liquidation, the result in many cases would be that little or no current tax would be imposed on the sale proceeds. The Congress believes that the nonrecognition provisions of section 337 should not apply to the sale of assets by a subsidiary when the simultaneous or ensuing liquidation of its parent falls under the liquidation rules of section 333.

The 1976 amendment to section 337 applied to a sale or exchange by a corporation which is a member of an affiliated group of corporations. However, the language of the amendment did not make completely clear at what point the existence of stock ownership for this purpose is to be determined. The Congress believes that this language should be clarified.

### ***Explanation of provision***

The 1978 Act makes the relief provided by the 1976 Act inapplicable where the parent (or common parent) is liquidated under the one-

month liquidation rules of section 333.<sup>1</sup> This provision will thus deny the benefit of section 337 where the corporation which sells assets is a first-tier subsidiary which then liquidates (under section 332) into its parent, after which the parent's shareholders liquidate that corporation under section 333.

If the corporation which sells property is a second-tier or lower subsidiary in a group of corporations, section 337 also is not to be available if any of the liquidations occurring at a higher point in the chain of ownership (which are otherwise required to occur) are governed by section 333.

In lieu of the reference to an affiliated group of corporations in the 1976 Act, the 1978 Act substitutes references to the selling corporation and to distributee corporations which are members of the chain of includible corporations. The selling corporation and each distributee corporation in the chain of includible corporations are required to liquidate completely within 12 months after the selling company adopts its liquidation plan. A "distributee corporation" is a corporation in the chain to which the selling company makes a liquidating distribution and each other company in the chain which in turn receives a liquidating distribution by reason of the liquidation of its transferor. The term "chain of includible corporations" is intended to have the same meaning as that term has in section 1504(a), which generally defines an affiliated group.<sup>2</sup> The reference to chains of includible corporations is substituted for the existing reference to an affiliated group in order to make clear that the liquidation requirements of the 1976 amendment apply only to those corporations which directly or indirectly own a stock interest in the selling company (other than through the common parent.)<sup>3</sup>

The definition of distributee corporation also is intended to make it clear that no corporation in which the selling company owns stock is required to liquidate under this provision. That is, the liquidation requirements apply only to corporations in the chain above the level of the selling company in the direction of the common parent; a subsidiary of the selling company which owns no stock of the selling company would not have to liquidate.

<sup>1</sup> Section 337 will not be available under this provision if gain is not recognized to the shareholders in whole or part pursuant to section 333. Thus, even if part of a shareholder's gain is taxable by reason of the special limitations in section 333, section 337 will not be available to the subsidiary.

<sup>2</sup> An includible corporation is determined under sec. 1504(a) by reference to 80 percent or greater ownership of a corporation by the common parent or one or more other includible corporations. To illustrate the operation of this definition, assume that a common parent, P, owns all the stock of sister subsidiaries S-1 and SS-1. S-1 owns 90 percent of the stock of a second-tier subsidiary, S-2. SS-1 owns the remaining 10 percent of the stock of S-2 and all the stock of its subsidiary, SS-2. If S-2 adopts a plan under section 337 and sells its assets, the corporations which must liquidate under this provision (in addition to S-2) are S-1, SS-1, and P.

The existence of an includible corporation continues to be determined without regard to the exceptions contained in section 1504(b).

<sup>3</sup> For example, if a common parent, P, owns all the stock of S-1, which in turn owns all the stock of S-2, which in turn owns all the stock of S-3, section 337 can apply to a sale of property by S-3 if the selling company liquidates into S-2. S-2 liquidates into S-1, S-1 liquidates into P, and P liquidates completely within 12 months after S-3 adopted its plan. If P had owned a separate group of subsidiaries, none of which owns any stock in the companies just described, none of the subsidiaries in the separate chain would be required to liquidate in order for section 337 to benefit S-3's sale. P's shareholders would be required, however, to receive P's stock in the parallel chain as part of P's liquidation.

The definition of distributee corporation also makes clear that the companies required to liquidate are determined by reference to the date on which a liquidating distribution is made rather than the date on which the distribution is received (which in some cases might be later than the date on which the transferor transmitted the distribution). The 1976 amendment was subject to a possible interpretation that a corporation in the chain which received a liquidating distribution from another corporation in the same chain might not be required to liquidate if the distributee actually received the distribution beyond the 12-month period.

The definitions in the Act also deal with changes in stock ownership of the selling company (or of another company in the same chain) after the selling company adopts its plan or sells assets and before it begins making distributions in liquidation. If the selling company is a member of a chain of includible corporations at the time the selling company makes a liquidating distribution, each corporate member of the chain receiving a liquidating distribution at that time must itself liquidate completely. Thus, for example, if a corporation is owned by one or more individuals at the time it adopts a section 337 plan and sells its assets, but is 80 percent or more owned by a corporate shareholder at the time it begins making distributions in liquidation, the corporate shareholder must liquidate completely even though that shareholder did not own stock of the selling company at the time the plan was adopted or the assets sold.

Even if a corporation which receives a liquidating distribution was not a member of the chain at the time the selling company liquidated, a "distributee corporation" must also liquidate completely within 12 months after the selling company adopted its plan. For example, assume that several individuals own all the stock of corporation B which in turn owns all the stock of corporation C. C adopts a section 337 plan on January 1, 1978, shortly thereafter sells some or all of its assets, and makes a liquidating distribution to B on June 1 of the same year. On July 1 of the same year, unrelated corporation A purchases all the stock of B. On September 1 of the same year B makes a liquidating distribution to A. Under the Act, section 337 will apply to C's gain on its sale of property only if A also liquidates completely within the 12 month period starting on January 1, 1978. Even though A and C were never in the same affiliated group or chain of includible corporations (because C had liquidated before A acquired B's stock). A must liquidate because within the 12-month period it became a distributee corporation (as described above).

### ***Effective date***

The provision applies to sales or exchanges pursuant to a plan of complete liquidation adopted after December 31, 1975.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

**10. Transactions Involving Two or More Investment Companies  
(sec. 701(j) of the Act and sec. 368(a)(2)(F) of the Code)**

***Prior law***

Under present law, as amended by the 1976 Act, tax-free "reorganization" treatment is denied to investment companies ("swap funds") and their shareholders and security holders if such company (or companies) owns an undiversified portfolio of stock or securities before the exchange (sec. 368(a)(2)(F)). Under an exception, this disallowance of tax-free reorganization treatment does not apply where the stock of each company is owned substantially by the same persons in the same proportions. However, under the swap fund rules, a realized loss can be created and deducted by a corporation or its shareholders and security holders where it results from an exchange among two or more "commonly-controlled" investment companies (if one of them has an undiversified portfolio), unless the corporate parties to the exchange are owned by substantially the same persons in the same proportions.

***Reasons for change***

The Congress believes that deductions of losses resulting from an exchange made taxable by the "swap fund" provision between one or more undiversified investment companies should be disallowed where more than 50 percent of the value of the stock of the corporate parties to the exchange is owned, directly or indirectly, by the same person.

***Explanation of provision***

Under the Act, a deduction of a loss resulting from an exchange made taxable by the "swap fund" provision between one or more undiversified investment companies will be disallowed if more than 50 percent in value of the outstanding stock of the corporate parties to the exchange are owned, directly or indirectly, by or for the same individual. The purpose of this rule is to prevent the deduction of losses not sufficiently realized to be properly deductible. This result will be achieved by applying the provisions of section 267(b)(3) of the Code to a loss realized by a party to the exchange which is an undiversified investment company immediately before the exchange. This provision will not affect the tax-free treatment of gains where substantially all of the stock of the investment company is owned by the same persons in the same proportions.

In addition, the Act modifies the definition of an investment company to parallel the percentage requirements for portfolio diversification which are otherwise applicable to reorganizations of two or more investment companies. In addition, the Act adds a specific definition of the term "securities" for purposes of the "swap fund" provision. Finally, the Act makes several changes in the language of the "reverse acquisition" rule in order to clarify the computation of the amount which shareholders will be deemed to realize in transactions to which this special rule applies.

***Effective date***

These changes apply as if included in the 1976 Act, except that the provisions relating to the nonrecognition of losses and to the treatment of commodity futures contracts as securities apply to transfers after September 26, 1977.

***Revenue effect***

This provision will increase budget receipts by less than \$1 million per year.

## **11. At Risk Provisions (sec. 701(k) of the Act and sec. 465 of the Code)**

### ***Prior law***

The 1976 Act contained a special effective date provision for application of the risk provision (sec. 465) to equipment leasing activities. Inadvertently, a cross-reference which referred to a provision describing farming activities should have referred to leasing activities.

In addition, the at risk provision provides generally that the amount of any loss (otherwise allowable for the taxable year) which may be deducted in connection with any one of certain activities (involving farming, oil and gas, motion pictures or video tape, or equipment leasing) cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. The intent of the provision was to treat amounts disallowed by reason of the at risk provision in the prior taxable year in the same manner as amounts paid or accrued from the activity to which section 465 applies in the current taxable year.

The definition of loss for a taxable year (sec. 465(d)) refers to the excess of the deductions allowable for the taxable year (determined without regard to the at risk provision) over the income received or accrued by the taxpayer during the taxable year from the activity. Thus, the provision is unclear as to whether the deductions entering into the computation of the loss for the current year include losses from prior years which, by virtue of section 465(a), were disallowed as deductions in those prior years.

### ***Reasons for change***

To clarify the computation of the loss for any current year, the Congress believes it to be appropriate to clarify the provisions of section 465(d) as to the treatment of losses disallowed in prior years solely by reason of the at risk provision (sec. 465(a)).

### ***Explanation of provision***

The 1978 Act amends subparagraph (A) of section 204(c)(3) of the Tax Reform Act of 1976, to refer to the special effective date provision for the application of the at risk provision to equipment leasing activities. This is a clerical change.

The 1978 Act also amends the definition of loss for the taxable year (sec. 465(d)) to clarify that the deductions entering into the computation of loss for the taxable year includes losses from prior years which, by virtue of section 465(a), are treated as deductions in the current year.

### ***Effective date***

The amendments made by this section are effective as of October 4, 1976 (the date of enactment of the 1976 Act).

### ***Revenue effect***

These provisions will have no effect on budget receipts.

**12. Amendments Relating to the Use of Accrual Accounting for Farming (sec. 701(1) of the Act and secs. 447 and 464 of the Code)**

***a. Automatic 10-year adjustment period for farming corporations and partnerships required to use accrual accounting (sec. 701(1)(1) of the Act and sec. 447 of the Code)***

***Prior law***

Prior to the 1976 Act, any taxpayer engaged in the trade or business of farming was entitled to use the cash method of accounting for such business and to deduct currently costs of a nature which, for other businesses, would be either included in inventory or capitalized.

The 1976 Act generally requires that certain farming corporations use an accrual method of accounting and capitalize preproductive period expenses. Exceptions are provided for subchapter S corporations, family corporations, certain small corporations, and taxpayers in the trade or business of operating a nursery. The Act also requires that certain farming partnerships (in which "nonexcepted" corporations are partners) use an accrual method of accounting and capitalize preproductive period expenses.

A transitional rule (sec. 447(f)) provided that a taxpayer who is required by this section to change its method of accounting can, except as otherwise provided in regulations, take the accounting adjustments required by this change into account over a ten-year period.

***Reasons for change***

The 1976 Act is unclear how the accounting adjustments are to be made in certain cases where either the taxpayer had not been in existence, or had been using a different method of accounting, during the 10 years prior to the year of change or where the taxpayer's future life was limited to fewer than 10 years from the year of change.

The Congress believes that it is equitable to allow a taxpayer who has been in existence for less than 10 taxable years, to be able to spread the adjustments over a period equal to 10 taxable years (or if lesser, its stated future life, if one is specified).

***Explanation of provision***

Under the Act, a corporation or partnership which is required by section 447 to change to an accrual method of accounting with capitalization of preproductive period expenses is permitted to take the accounting adjustments required by such change into account over a 10-year period except in those situations where a corporation or partnership has a stated future life of less than 10 years. In cases where the corporation or partnership has a stated future life of less than 10 years, these adjustments may be taken into account ratably over its stated future life.

The determination as to the stated future life of an organization is to be made as of the first day of the first taxable year for which an



accounting change is required. Thus, for instance, if a partnership agreement contains a provision limiting the future life of the partnership to a stated period and also contains an agreement whereby such partnership agreement may be amended to extend the life of the partnership, the provision to permit an extension is to be disregarded if the partnership agreement has not been amended to provide for such extension as of the first day of the year of change.

### ***Effective date***

This provision is effective as of October 4, 1976 (the date of enactment of the 1976 Act).

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

### ***b. Automatic 10-year adjustment for farming syndicates changing to accrual accounting (sec. 702(1)(2) of the Act and sec. 464 of the Code)***

#### ***Prior law***

Prior to the 1976 Act, any taxpayer engaged in the trade or business of farming was entitled to use the cash method of accounting for such business and to deduct currently costs of a nature which, for other businesses, would be either included in inventory or capitalized.

The 1976 Act provides limitations on certain types of deductions for farming syndicates. These limitations generally require farming syndicates (1) to defer deducting the cost of prepaid feed, seed, fertilizer, or other supplies until the supplies are used or consumed, (2) to capitalize or inventory certain preproductive period expenses of poultry, and (3) to capitalize preproductive period expenses of orchards and vineyards.

No transitional rules were provided for farming syndicates affected by this provision. Thus, if a farming syndicate wishes to change to an accrual method of accounting with capitalization of preproductive period expenses, it must, under the ordinary rules, obtain the consent of the Internal Revenue Service, and the Internal Revenue Service would have broad discretion to determine the period (if any) over which the farming syndicate would have to spread the adjustments required by the change in accounting method.

#### ***Reasons for change***

The Congress understands that certain farming syndicates may wish to elect to use an accrual accounting method with capitalization of preproductive period expenses. Since this method of accounting more accurately matches income and expenses than the cash method of accounting (even as modified by the farming syndicate rules), the Congress believes that it is appropriate to provide a generous transition period to encourage farming syndicates to change voluntarily to this method. In addition, certain farming syndicates have been able to take advantage of a 10-year transitional rule provided in section 447 of the Code because they are partnerships with corporate general partners. However, other farming syndicates with individuals as general partners have been ineligible to use this transitional rule because

section 447 of the Code does not require them to change to an accrual method of accounting.

### ***Explanation of provision***

The Act provides that, if a farming syndicate was in existence on December 31, 1975 (the date immediately prior to the effective date of the farming syndicate provisions of the 1976 Act), and the syndicate elects to change to an accrual method of accounting with capitalization of preproductive period expenses (described in section 447(b)) for a taxable year beginning before January 1, 1979, the change of method of accounting will be treated as having been made with the consent of the Service and the net amount of the accounting adjustment required to be taken into account shall be spread over a period of 10 taxable years starting with the year of change (or ratably over the syndicate's remaining taxable years where the syndicate has a stated future life of less than 10 years).

This provision is to be available only if the farming syndicate changes to an accrual method of accounting with capitalization of the preproductive period expenses referred to in section 447(b). It is not intended to apply to a taxpayer seeking to change to the "annual accrual method of accounting" under section 447(g).

In determining whether a farming syndicate (such as a partnership) has a stated future life of less than 10 years, and in determining the number of years of such stated future life, reference is to be made to the circumstances as of the first day of the year of change of the accounting method. Thus, for instance, if a partnership agreement contains a provision limiting the future life of the partnership to a stated period and also contains an agreement whereby such partnership agreement may be amended to extend the life of the partnership for a further period, the provision to permit an extension will be disregarded if the partnership agreement has not been amended to provide for such extension as of the first day of the year of change.

### ***Effective date***

This provision is effective as of October 4, 1976 (the date of enactment of the 1976 Act).

### ***Revenue effect***

This provision will reduce budget receipts by less than \$2 million per year.

### ***c. Extending family attribution to spouses in the farming syndicate rules (sec. 701(1)(3) of the Act, and sec. 464 of the Code)***

#### ***Prior law***

Prior to the 1976 Act, any taxpayer engaged in the trade or business of farming was entitled to use the cash method of accounting for such business and to deduct currently costs of a nature which, for other businesses, would be either included in inventory or capitalized.

The 1976 Act provided limitations on certain types of deductions for farming syndicates. These limitations generally require farming syndicates (1) to defer deducting the cost of prepaid feed, seed, fertilizer or other supplies until the supplies are used or consumed, (2) to capi-

talize or inventory certain costs of poultry, and (3) to capitalize pre-productive period expenses of orchards and vineyards.

In general, farming syndicates were defined to include (1) any partnership or other noncorporate enterprise engaged in farming if interests in the business were required to be registered with a Federal or State securities agency and (2) any partnership or other noncorporate enterprise engaged in farming if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs. Generally, limited entrepreneurs and limited partners are individuals who do not actively participate in management of the activity. Certain interests in farming enterprises are not treated as interests held by limited partners or limited entrepreneurs if the interests are attributable to active participation in farm management or certain other qualifications are met by an individual or certain family members of that individual. For purposes of this rule, a family is determined by reference to the grandparent of an individual, and family members are members of the grandparent's family. However, under the language of this provision, the individual's spouse and the spouses of other family members other than the grandparent are not included as family members.

#### ***Reasons for change***

The omission of spouses of members of a family in the family member rules of the farming syndicate provisions was a technical oversight.

#### ***Explanation of provision***

This provision expands the family member rules of the farming syndicate provisions to cover the spouses of family members.

#### ***Effective date***

This provision is effective as of October 4, 1976 (the date of enactment of the 1976 Act).

#### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

### **13. Extensions of Certain Provisions to Foreign Personal Holding Companies (sec. 701(m) of the Act and secs. 189 and 280 of the Code)**

#### ***Prior law***

The 1976 Act contained a number of provisions to limit taxpayers' use of tax shelters. One of these provisions provides that certain real property construction period interest and taxes are to be capitalized in the year in which they are paid or accrued and amortized over a period of years, generally 10 years (sec. 189). Another section requires the capitalization of the costs of producing motion pictures, books, records, and other similar property and permits the deduction of these capitalized costs over the life of the production activity (sec. 280). Both of these provisions apply to individuals, estates, trusts, subchapter S corporations and personal holding companies. These provisions do not apply to other corporations.

In general, these provisions were applied only to situations where the deductions would reduce the taxable income of individuals (or estates and trusts). However, these rules also were made applicable to personal holding companies, which are certain domestic corporations receiving investment income or compensation of its shareholders in order to shield that income from the higher individual tax rates that would apply if the income were received by the shareholders.

#### ***Reasons for change***

Since a foreign personal holding company can be used to shelter income from the individual income tax rates, the Congress believes the two tax shelter provisions discussed above also should apply to foreign personal holding companies.

#### ***Explanation of provision***

The Act makes the provisions of the Internal Revenue Code of 1954, relating to the amortization of real property construction period interest and taxes (sec. 189) and the capitalization of costs of producing motion pictures, books, records and other similar property (sec. 280) applicable to foreign personal holding companies in the computation of their taxable income.

#### ***Effective date***

These provisions generally are effective for taxable years beginning after December 31, 1975.

#### ***Revenue effect***

This provision will increase budget receipts by less than \$2 million per year.

#### **14. Definition of Condominium Management Association (sec. 701(n) of the Act and sec. 528 of the Code)**

##### ***Prior law***

The Tax Reform Act of 1976 added a provision to the Internal Revenue Code (sec. 528) which permits certain homeowners associations to elect to be treated as tax-exempt with respect to their exempt function income. The homeowners associations which are eligible to make this election include condominium management associations and residential real estate management associations which satisfy certain statutory requirements. Under the 1976 Act, the definition of a residential real estate management association requires that substantially all of the lots or buildings of the subdivision, development, or similar area which the association serves "may only be used by individuals for residences" (sec. 528(c)(3)), but similar requirements for condominium management associations require that the units of the condominium project be "used as residences" (sec. 528(c)(2)).

##### ***Reasons for change***

In order to make it clear that no distinction was intended with respect to the differences in definitions between a condominium management association and a residential real estate management association, the Congress believes it is appropriate to conform the definitions of the two types of homeowners associations.

##### ***Explanation of provision***

The Act conforms the definitions of condominium management association with that of residential real estate management association by providing that all of the units of a condominium project be "used by individuals for residences." Thus, the Act makes it clear that no distinction was intended to be made between the two types of associations in this respect.

##### ***Effective date***

The amendment is applicable to taxable years beginning after December 31, 1973.

##### ***Revenue effect***

This provision has no effect on budget receipts.

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**15. Personal Holding Companies—Definition of “Individual” for Stock Ownership Test (sec. 701(o) of the Act and sec. 542 of the Code)**

***Prior law***

Under present law, a tax is imposed on the undistributed income of a “personal holding company.” Basically, a “personal holding company” is a corporation which derives most of its income from certain passive sources and 50 percent or more of whose stock is owned by 5 or fewer individuals.

Under the law prior to the Tax Reform Act of 1976, an organization or trust organized or created before July 1, 1950, would not be counted as an individual in determining whether a corporation constituted a personal holding company if the organization or trust owned all of the common stock and at least 80 percent of the other stock of the corporation. The 1976 Act deleted this last exception as part of the “deadwood” provisions of that Act.

***Reasons for change***

The “deadwood provisions” in the 1976 Act were designed to simplify the tax law by removing from the Internal Revenue Code those provisions which are no longer used in computing current taxes or are little used and of minor importance. In the case of this provision, it has come to the attention of the Congress that at least one company still comes within the provision eliminated under the deadwood provisions. Since the definition of personal holding company was modified by the “deadwood” provisions of the 1976 Act pursuant to the belief that no taxpayer any longer qualified under its terms, the Congress believes it to be appropriate to reinstate the exception.

***Explanation of provision***

The amendment reinserts the provision of prior law that was deleted by the deadwood provisions of the 1976 Act.

***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

## 16. Gain on Sale of Certain Property Transferred in Trust (sec. 701(p) of the Act and sec. 644 of the Code)

### *Prior law*

The 1976 Act added a new provision (sec. 644) which taxes a trust at the transferor's rate brackets where the trust disposes of an asset within 2 years of its transfer to the trust by the transferor. The statute applies to any gain *realized* by the trust, even if that gain would not be *recognized* by the trust under other provisions of the Code that provide for tax-free treatment in certain situations. Thus, for example, the new provision apparently would apply to stock exchanged in a tax-free reorganization of a corporation by the trust if the stock had been transferred to the trust less than 2 years before the reorganization.

In addition, the application of the new provision is unclear where the transferor has items, such as charitable contributions, net operating losses, and capital losses, that are carried back or over from the transferor's taxable year in which the property was sold by the trust to another year.

Also, where the transferor incurs a net operating loss within three years after the year in which the transferred property was sold, the transferor may be permitted to carry back the net operating loss and thus reduce his taxable income for the year in which the transferred property was sold. In such a case, the trust would apparently be entitled to file a claim for refund since its tax under this new provision is based on the transferor's rate bracket.

Generally, the new provision applies regardless of whether the trust elects to report income under the installment method for reporting gain on a sale or exchange. However, the "includible gain" does not include any portion of an installment received by the trust after the death of the transferor.

### *Reasons for change*

The Congress believes that the new provision should only apply to gains *recognized* by the trust. However, the Congress also believes that the new provision should apply to the property received in a tax-free exchange to the same extent that the provision applied to the property transferred in the tax-free exchange.

In addition, the Congress believes that it should not be possible for both the trust and the transferor to obtain the benefit of an item through the carryover of that item to another year of the transferor.

Moreover, because of the administrative difficulties which would arise if the trust is permitted to take into account a net operating loss carryback of the transferor, the Congress believes that the tax under the new provision should be computed without regard to any net operating loss carryback of the transferor.

Finally, the Congress wishes to clarify that the provision applies where installment reporting of gain on the sale or exchange of property

is elected and installment payments with respect to the purchase price are made in two or more years.

### ***Explanation of provision***

The Act provides that the new rule applies only to gains *recognized* by the trust under the normal rules governing tax-free transactions. However, the Act provides that the new provision will apply to property received in a tax-free exchange to the same extent that it would have applied to the property given up in the tax-free exchange.

In addition, the Act provides that the tax computation under the new provision is to be determined without regard to any loss or deduction which is carried (either back or forward) to another year of the transferor. For example, assume that the transferor had \$10,000 of ordinary business income in the year in which the transferred property is sold and that the includible gain on the transferred property was \$20,000. If the transferor had a long-term capital loss in 1977 or a long-term capital loss carryover to that year of \$5,000, then \$1,000 of the loss would be disregarded because it is carried over to the transferor's following taxable year (total long-term capital loss of \$5,000 reduced by \$4,000 which is the amount considered used to determine to a maximum \$2,000 capital loss deductible against ordinary income for 1977 (\$3,000 for 1978) at 50 percent of the long-term capital loss.)

In addition, the Act provides that the tax under the new provision is to be computed without regard to any net operating loss carrybacks to the transferor's taxable year which are used to determine the applicable tax rate. However, the tax is computed with regard to net operating loss carryovers from prior years and any net operating loss for the year of sale, to the extent no carryback or carryover arises from that year. For example, assume the same facts above, except that the transferor has a net operating loss carryforward from prior years of \$5,000 and no capital losses. In this case, the tax under the new provision is computed by taking the entire amount of the \$5,000 net operating loss deduction into account since none of the net operating loss deduction can be carried forward to another year of the transferor. However, if the net operating loss carryforward were \$12,000, then the tax under the new provision would be computed by allowing a net operating loss deduction of \$10,000 since \$2,000 can be carried over to another year of the transferor. Where, however, the year of sale is the last year to which a net operating loss deduction can be carried (generally 7 years), then the tax under the new provision is computed with regard to the full net operating loss deduction since any excess net operating loss deduction of the transferor cannot be carried over to another year of the transferor.

Finally, in the case of installment sales, each installment is taxed at the grantor's tax rate if the installment sale occurred within the two year period after the transfer to the trust. In other words, the provision applies where a trust elects to report income under the installment sale method as if each installment were a separate sale or exchange of property to which the provision applied, without regard to the two year rule.



The Act also removes a conforming amendment in the capital gains throw-back rule which was repealed by the 1976 Act since the enactment of the new provision (sec. 644) removed the need for such a conforming amendment.

***Effective date***

The provisions generally apply to transfers in trust made after May 21, 1976. The removal of the conforming amendment in the capital gains throw-back rules is effective on October 4, 1976 (the date of enactment of the 1976 Act).

***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

## **17. Allowance of Foreign Tax Credit for Accumulation Distributions (sec. 701(q) of the Act and secs. 665 and 667 of the Code)**

### ***Prior law***

Prior to the 1976 Act, distributions from trusts of accumulated income were taxed in substantially the same manner as if the income were distributed when earned. The 1976 Act made several modifications in the manner in which accumulation distributions are taxed. Under the Act, accumulation distributions are thrown back to three of the five preceding years, excluding those years with the highest and lowest incomes, and are taxed at the beneficiary's rates for those years with a credit for any U.S. taxes imposed on the trust. The 1976 Act does not permit refunds of excess taxes paid by the trust. In addition, the accumulation distributions generally do not retain, in the hands of the beneficiary, the character of the income from which they were distributed.

### ***Reasons for change***

The modifications made by the 1976 Act to the taxation of accumulation distributions leave unclear whether beneficiaries may claim a credit with respect to foreign taxes paid by the trust which are allocable to accumulation distributions and, if such a credit is allowed, how it is computed. The Congress believes that beneficiaries should be permitted to claim a tax credit with respect to foreign taxes allocable to accumulation distributions so that the treatment of current and accumulation distributions are substantially similar in this regard.

### ***Explanation of provision***

The Act adopts two separate rules: one for distributions from domestic accumulation trusts and the other for distributions from foreign accumulation trusts.

With respect to distributions from domestic accumulation trusts, the Act clarifies the operation of the credit mechanism by defining "taxes imposed on the trust" as the gross Federal income tax before credits allocable to the distribution. Thus, the benefit of any foreign tax credit, investment credit, or any other credit allowed under subpart A of part IV of subchapter A of the Code (secs. 31 through 45) claimed by the trust in a prior accumulation year is flowed through to the beneficiary when the accumulated income of such year is distributed. The credits are not passed through as identifiable amounts, but rather comprise a portion of U.S. tax imposed on the trust which may be offset against the partial tax on the distribution. Since any applicable limitations on the credits were computed and applied at the trust level, no further limitations (other than the denial of refund for taxes imposed on the trust in excess of the partial tax) are imposed. There is no requirement under the Act that the beneficiary elect the foreign tax credit for the year of distribution.

A separate rule is provided under which foreign income taxes allocable to accumulation distributions from foreign trusts are allowed as a credit in computing the partial U.S. tax on the distribution.

Under the Act, the definition of "taxes imposed on the trust" (sec. 665(d)) is amended to include, in the case of foreign trusts, the foreign taxes paid or accrued by the trust that are properly allocable to the accumulation distribution. As a consequence, the amount of such taxes is deemed to have been distributed to the beneficiary and is includible in his gross income along with the actual trust distribution (secs. 666(b) or (c) and 667). As in the case of a domestic trust, a partial tax is computed with respect to the total distribution using the throwback rules (sec. 667(b)). In computing the partial tax in the case of a foreign trust, however, the deemed distributed foreign income taxes included in income in a computation year are allowed, subject to the foreign tax credit limitations, as a credit against the increase in tax for that year. In contrast, U.S. taxes imposed on the trust are allowed as an offset against the partial tax on the distribution in the distribution year (determined on the basis of the average increase in tax for the three computation years).

The foreign tax credit limitations are applied in computing the partial tax in the case of distributions from foreign trusts because, in contrast to domestic trusts, foreign trusts are not generally subject to U.S. tax on the income when accumulated, and thus the foreign tax credit limitations have not been applied at the trust level. Foreign taxes in excess of these limitations are not available for carryover or carryback. (This corresponds to the treatment of U.S. taxes attributable to accumulation distributions; they are allowed as an offset against the partial tax, but no carryovers are allowed for any excess).

The limitations on the foreign tax as a credit against the increase in tax in each of the computation years are applied separately to the accumulation distribution as compared with other items in the beneficiary's return for such year. Further, foreign taxes included in income in the computation year by reason of the accumulation distributions may be claimed only against the increase in tax for the computation year. The separate limitations on the trust distribution are computed in the same manner as the separate limitations on foreign taxes related to foreign source interest and DISC dividends. That is, the numerator of the limiting fraction is the portion of the income added to the beneficiary's taxable income for the computation year which is from foreign sources (or which is foreign oil-related income, interest income, or DISC income); the denominator is the sum of the worldwide taxable income of the beneficiary for the computation year and the income added to his taxable income for purposes of computing the increase in tax; and the tax to which the fraction is applied is the sum of the total U.S. tax of the beneficiary for the computation year and the increase in tax for that year. The items of income, deduction, and credit of the trust retain their character and source to the extent necessary to apply these rules.

If the beneficiary elected the foreign tax credit on his return for a computation year, he must credit the foreign taxes deemed distributed by the trust in computing the increase in tax for that year. If the beneficiary did not elect the foreign tax credit on his return for the computation year, he may either treat the foreign tax imposed on the

trust as a deduction or a credit in determining the increase in tax for that computation year. If the beneficiary deducted other foreign taxes in the computation year, he will not merely by reason of the throw-back rules, be required to amend his return for that year and recompute the tax as if the foreign taxes had been claimed as a credit. However, if the beneficiary deducted foreign taxes on his return for the computation year but elects to credit foreign taxes included in the accumulation distribution in computing the increase in tax for that year, the increase in tax is the difference between (i) the tax on the beneficiary's taxable income for that year, computed by deducting foreign taxes and (ii) the tax on the sum of the beneficiary's taxable income, plus the amount added under section 667(b)(1)(C), plus the amount of foreign taxes originally deducted for that year, computed by creating both the foreign taxes imposed on the trust and the foreign taxes paid or accrued by the beneficiary in the computation year.

A special rule is provided for the application of the foreign loss recapture rules (sec. 904(f)) to accumulation distributions from foreign trusts. If the beneficiary sustained an overall foreign loss (or foreign oil-related loss) in a taxable year prior to the distribution year, the portion of the accumulation distribution which is out of foreign source income (or foreign oil-related income) of the trust will be recaptured (i.e., treated as U.S. source income for purposes of computing the credit in the computation year) to the extent that the loss has not been recaptured (i) in intervening years or (ii) against any foreign source taxable income (or foreign oil-related income) of the beneficiary in the distribution year other than the accumulation distribution. The recapture will apply to the entire amount of the foreign source income included in the accumulation distribution (the 50 percent of foreign source taxable income limitation of sec. 904(f)(1)(B) will not apply). By recapturing the unused loss against the accumulation distribution, the trust income added to each of the computation years is treated as income from U.S. sources in the proportion that the loss recaptured against the accumulation distribution bears to the total accumulation distribution (including the foreign taxes deemed distributed).

The application of this rule is illustrated by the following example. A beneficiary of a foreign accumulation trust receives a distribution in 1980 of \$20,000 of foreign source income. The foreign tax paid or accrued by the trust that is properly allocable to such income is \$4,000. The three computation years chosen after application of section 667(b)(1)(C) are 1975, 1977, and 1978. The beneficiary incurred an overall foreign loss in 1979 of \$10,000. He does not have any foreign source income in 1980 other than that from the trust distribution. The amount to be added to taxable income in each computation year is \$12,000 (the sum of the actual distribution (\$20,000) plus the deemed distributed taxes (\$4,000) divided by the number of accumulation years (2)). The foreign loss recapture rules require that 10/24 (\$10,000 recaptured loss over the \$24,000 total distribution) of the income added to each computation year be treated as U.S. source income. Thus, \$5,000 of the income added to each computation year is U.S. source and \$7,000 is foreign source for the purposes of computing the foreign tax credit limitations in those years.

***Effective date***

The amendments made by this provision apply generally to distributions made in trust taxable years beginning after December 31, 1975. However, the amendment coordinating the loss recapture rules with the accumulation distribution amendments applies to losses sustained in taxable years of beneficiaries beginning after December 31, 1975.

***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

## **18. Source and Character of Accumulation Distributions from Trusts (sec. 701(r) of the Act and sec. 667 of the Code)**

### ***Prior law***

The 1976 Act substantially changed the treatment of distributions of income accumulated by trusts in years prior to the distribution. One of those changes is that distributions of previously accumulated income, other than those attributable to tax-exempt interest, do not retain in the hands of the beneficiary, the character of the income from which they were distributed. In the case of distributions of previously accumulated income to nonresident aliens and foreign corporate beneficiaries, the elimination of the characterization rules leaves unclear how to determine the amount, if any, of U.S. withholding tax to be imposed on the distribution.

### ***Reasons for change***

Because of the necessity of knowing the character of the income in applying the U.S. withholding tax on distributions to nonresident aliens and foreign corporations, the Congress believes that the character of income should be retained in the case of accumulation distributions to these persons.

### ***Explanation of provision***

The Act reinstates the rules that applied prior to the 1976 Act (under sec. 662(b)) with respect to accumulation distributions to nonresident aliens and foreign corporations. Thus, distributions by a trust of previously accumulated income made to nonresident aliens and foreign corporate beneficiaries will retain the character of the income from which the distributions are made.

### ***Effective date***

The amendment is effective for accumulation distributions made in taxable years beginning after December 31, 1975.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

## **19. Exempt-Interest Dividend of Regulated Investment Companies (sec. 701(s) of the Act and sec. 851 of the Code)**

### ***Prior law***

A regulated investment company (commonly called a mutual fund) is permitted a deduction for dividends paid to its shareholders if it meets several tests. One of the tests is that at least 90 percent of its gross income must be derived from dividends, interest, and gains from the sale or other disposition of stocks or securities. Another of the tests is that less than 30 percent of its gross income must be derived from the sale or other disposition of stock or securities held for less than 3 months.

The 1976 Act contained an amendment to the provisions dealing with regulated investment companies which permits a company to pay exempt-interest dividends to its shareholders if at least 50 percent of its assets are invested in tax-exempt State and local governmental obligations. However, interest on tax-exempt State and local governmental obligations is not included in gross income. Consequently, a regulated investment company investing all or most of its assets in tax-exempt obligations could fail to meet the 90- and 30-percent tests if, for example, it recognizes a relatively small amount of nonqualifying income.

Also, a shareholder may invest in an open end tax-exempt mutual fund shortly before the record date of a future dividend and then tender his share for redemption immediately after the receipt of the tax-exempt interest dividend. Since the fund's assets have been depleted by the amount of the dividend, the shareholder will generally recognize a short-term capital loss on the redemption in the amount of the dividend. The net effect of the two transactions is to create an artificial short-term capital loss which can be used to shelter other capital gains of the shareholder.

### ***Reasons for change***

The Congress believes that the tests for determining whether a corporation qualifies as a regulated investment company should be made by including tax-exempt interest in gross income. In addition, the Congress believes that it should not be possible to create an artificial loss through the purchase and sale of shares in a regulated investment company that pays exempt-interest dividends.

### ***Explanation of provision***

The Act provides that "gross income" for purposes of the 90- and 30-percent tests includes tax-exempt interest. In addition, the Act disallows any loss recognized within 31 days of the date of purchase on shares in a tax-exempt mutual fund to the extent of any exempt interest dividend received by the shareholder.

***Effective date***

The amendments made by this section are effective for taxable years beginning after December 31, 1975.

***Revenue effect***

This provision has no effect on budget receipts.



## **20. Real Estate Investment Trusts (sec. 701(t) of the Act and sec. 859 of the Code)**

### ***Prior law***

Real estate investment trusts (REITs) are treated under the tax law in a manner similar to mutual funds, so that if a qualifying REIT distributes at least 90 percent of its income to the shareholders, the income is taxed to the shareholders and not to the REIT. There are several income source tests which must be satisfied in order to qualify as a REIT, among which is the requirement that at least 75 percent of the trust's gross income must come from rents, interest on mortgages and other sources related to the holding of real estate for investment.

The 1976 Tax Reform Act made extensive changes to the provisions relating to taxation of REITs and their shareholders. Under prior law, for example, a REIT could elect a fiscal year, and, if its shareholders used the calendar year for tax purposes, the shareholders could obtain a delay of up to two years in reporting income flowed through from the REIT. The 1976 Act provided that a REIT could not in the future adopt or change to any annual accounting period other than the calendar year.

Prior law also prohibited a REIT from holding property, other than property qualifying as foreclosure property, for sale to customers in the ordinary course of business. The 1976 Act permits REITs to hold such property; however, the net income from the sale of the property is taxed at a rate of 100 percent. In addition, gains derived from such property generally do not qualify for purposes of meeting the income source tests.

### ***Reasons for change***

The Congress noted that the provisions in the 1976 Act requiring a taxable year did not specifically require a newly electing REIT to adopt a calendar year if it had previously adopted a fiscal year for tax purposes. It was also noted that, under the amendments made by the 1976 Act, it was possible for gain derived from shares in another REIT to qualify for the 75-percent income source test even though these shares were held primarily for sale.

### ***Explanation of provision***

The Act amends the REIT taxable year provisions to require that any corporation, trust, or association which first qualifies for REIT status after October 4, 1976, must adopt or change to a calendar year in order to be eligible for REIT status. In addition, the Act clarifies the income source rules to require that, for purposes of the 75-percent income source test, qualifying income does not include gain from the sale of REIT shares which were held primarily for sale. The Act also corrects several erroneous or omitted cross references which relate to the REIT amendments in the 1976 Act.

***Effective date***

These provisions are effective as of October 4, 1976 (the effective date of the 1976 Tax Reform Act).

***Revenue effect***

This provision has no effect on budget receipts.

## **21. Amendments Relative to the Treatment of Foreign Income (sec. 701(u) of the Act)**

### ***a. Taxation of possessions corporations (secs. 701(u)(1) and (11) of the Act and secs. 901(g) and 936 of the Code)***

#### ***Prior law***

The 1976 Act restructures the taxation of U.S. corporations substantially all of whose operations are in Puerto Rico and the possessions ("possessions corporations"). In brief, the Act provides that possessions corporations are entitled to a tax credit equal to the U.S. tax which otherwise would be paid on the income derived from the active conduct of a trade or business in a possession or from investments in the possession of the earnings from a possessions business.

A recent Tax Court case (*Kewanee Oil Co.*, 62 T.C. 728) has held that the sale of substantially all the assets of a trade or business does not, for purposes of the Western Hemisphere trade corporation provisions, constitute income derived from the active conduct of a trade or business. The 1976 Act does not specify the treatment of this type of sale for purposes of the possessions tax credit.

In addition to the tax credit for income earned by possessions corporations, the 1976 Act provides that corporate shareholders are entitled to the dividends-received deduction with respect to dividends from possessions corporations. As a result, Congress decided that it was inappropriate to allow a foreign tax credit for taxes imposed on distributions from possessions corporations to U.S. shareholders which are also partially or fully exempt from U.S. tax because of the dividends-received deduction or other nonrecognition provisions. However, the 1976 Act (sec. 901(g)) disallows the credit even where the distribution was fully subject to U.S. tax. For example, the credit is denied with respect to withholding taxes on dividends from possessions corporations which are received by individuals although individuals are not entitled to the dividends-received deduction.

#### ***Reasons for change***

The recent Tax Court case involving a sale of substantially all of the assets of a Western Hemisphere trade corporation can result in an implication that, in a similar situation, a sale of assets by a possessions corporation will not qualify for the possessions tax credit. The Congress believes that this implication was not intended under the 1976 Act.

In addition, the 1976 Act provision disallowing any foreign tax credit on dividends from possessions corporations was intended to apply only where those dividends are exempt (or substantially exempt) from U.S. tax. The Congress believes it is necessary to make conforming changes to carry out this intention.

### ***Explanation of provision***

The Act makes it clear that taxable income from the sale of substantially all the assets which had been used by a possessions corporation in the active conduct of a possession business may qualify for the possessions tax credit. In addition, the Act provides that income from the sale or exchange by a possessions corporation of any asset generally will not qualify for the credit if the basis of the asset (for purposes of determining the gain on the sale or exchange) is determined in whole or in part by reference to its basis in the hands of another person. Gain on the sale of an asset with a carryover basis will qualify, however, if the person (or persons) whose basis in the asset has been carried over was, for the entire period that the person held the stock, a possessions corporation (under sec. 931 or 936) or a corporation organized in Puerto Rico or a possession and described in section 957(c).

The Act also provides that the denial of the foreign tax credit with respect to taxes imposed on distributions from possessions corporation does not apply where the distribution is fully taxable by the U.S. Where the recipient of the distribution (including an indirect recipient such as a corporate partner of a partnership or corporate beneficiary of a trust which directly receives the dividend) is entitled to a dividends-received deduction attributable to the distribution, the credit is denied with respect to the full amount of the taxes imposed on the distribution. Where the distribution is received in connection with a liquidation or other transaction, the credit is denied to the extent that the taxes are imposed on income, gain or loss which is not recognized for U.S. tax purposes by the recipient. The Act also makes it clear that the disallowance of the credit also applies in the case of distribution from corporations described in section 957(c) in situations where income, gain, or loss is not recognized.

### ***Effective date***

The provision generally applies to taxable years beginning after December 31, 1975. The provision disallowing foreign tax credits in the case of distributions from section 957(c) corporations applies to distributions made after the date of enactment (November 6, 1978).

### ***Revenue effect***

This provision will reduce budget receipts by less than \$10 million in fiscal year 1978 and by less than \$5 million annually thereafter.

### ***b. Foreign tax credit adjustments for capital gains (secs. 701(u)(2) and (3) of the Act and sec. 904 of the Code)***

#### ***Prior law***

The 1976 Act made several adjustments to the computation of the foreign tax credit to take account of the fact that capital gains are taxed differently from ordinary income. Section 904(b)(2) of the Code, as added by section 1031 of the 1976 Act, establishes the rules for determining the manner in which income and loss from the sale of capital assets is taken into account in computing the credit. However, the provision applies those adjustments only for the computation of the limitation itself and not for other purposes.

### ***Reasons for change***

The 1976 Act leaves unclear whether the adjustments required for capital gains income apply before or after other adjustments required (under sec. 904) in order to compute a taxpayer's foreign tax credit limitation. For example, it is not clear in the statute whether the loss recapture rules (of sec. 904(f)) apply before or after any capital gains adjustments. In addition, it is unclear whether the reduction provided for in the 1976 Act in the amount of foreign capital losses taken into account in computing the numerator of the foreign tax credit limiting fraction does not apply to capital loss carryovers and carrybacks.

### ***Explanation of provision***

The Act provides that the adjustments with respect to capital gains and losses apply for all foreign tax credit limitation purposes (i.e., sec. 904) so that the adjustments are applicable for loss recapture purposes. In addition, the Act amends clause (iii) of section 904(b) (2) (A) to make it clear that the three-eighths reduction provided with respect to foreign capital losses which offset U.S. source net capital gains is to be made only in computing the numerator of the limiting fraction and to provide that the adjustment is also made where the foreign capital loss is a capital loss carried forward from a preceding year or carried back from a succeeding taxable year.

### ***Effective date***

The provision applies to taxable years beginning after December 31, 1975.

### ***Revenue effect***

This provision has no effect on budget receipts.

### ***c. Treatment of capital loss carryovers and carrybacks for recapture purposes (sec. 701(u)(4) of the Act and sec. 904 of the Code)***

#### ***Prior law***

The 1976 Act provides that where a taxpayer has an overall foreign loss (or a foreign oil related loss) in one year, that loss is to be recaptured by recharacterizing foreign source income (or foreign oil related income) earned in future years as U.S. source income for foreign tax credit limitation purposes. An overall foreign loss is the amount by which foreign source gross income is exceeded by the deductions attributable thereto; a foreign oil related loss is the amount by which foreign oil related income is exceeded by deductions attributable thereto. Since foreign net operating losses carried to other years are included in the computation of the overall foreign loss or foreign oil related loss in the year sustained for recapture purposes, net operating loss carryovers or carrybacks are excluded from the computation of any overall foreign loss or foreign oil related loss for the year in which deducted in order to prevent a double counting of the loss. The 1976 Act similarly excludes capital loss carrybacks and carryovers from overall foreign loss and foreign oil related loss.

### ***Reasons for change***

Since capital losses are deductible only to the extent of capital gains (plus a limited amount allowed to offset ordinary income of individuals under sec. 1211(b)), foreign capital losses which are not de-

ductible in the year incurred are not included in overall foreign loss or foreign oil related loss in either the year sustained or the year to which carried. Thus, they are not subject to recapture. This exclusion of capital loss carryovers from the loss recapture provisions was not intended.

### ***Explanation of provision***

The Act amends the definition of overall foreign loss and foreign oil related loss to eliminate the exception for capital loss carryovers and carrybacks. Thus, such losses will be subject to recapture to the extent they are used as carryovers or carrybacks in years in which the taxpayer has an overall foreign loss or a foreign oil related loss.

### ***Effective date***

The provision applies to taxable years beginning after December 31, 1975.

### ***Revenue effect***

This provision will increase budget receipts by less than \$1 million per year.

### ***d. Effective date of recapture of foreign oil related losses (sec. 701(u)(5) of the Act and sec. 904 of the Code)***

#### ***Prior law***

The provisions requiring recapture of foreign oil related losses were added to the Code by the Tax Reduction Act of 1975. The provisions applied to losses sustained in taxable years ending after December 31, 1975. The 1976 Act modified the rules relating to recapture of foreign oil related losses and extended recapture to all foreign losses.

#### ***Reasons for change***

The modifications to the foreign oil related loss recapture rules were intended to apply retroactively to the effective date of those rules under the Tax Reduction Act. However, the effective date of the 1976 Act modifications is taxable years *beginning* after December 31, 1975, rather than taxable years *ending* after December 31, 1975 (the effective date of the oil related loss recapture rules under the Tax Reduction Act).

### ***Explanation of provision***

The Act corrects this technical defect by providing that the modifications dealing with recapture of foreign oil related income made by the 1976 Act apply to taxable years ending after December 31, 1975.

### ***Effective date***

This provision is effective upon enactment.

### ***Revenue effect***

The provision has no effect on budget receipts.

### ***e. Transitional rule for recapture of foreign losses (sec. 701(u)(7)(A) of the Act and sec. 904(f) of the Code)***

#### ***Prior law***

Prior to the Tax Reform Act of 1976, foreign losses generally reduced U.S. tax on U.S. source income by decreasing the worldwide taxable income on which the U.S. tax was based. In addition, when

the business operations in the loss country (or countries) became profitable, a credit against U.S. tax was allowed for taxes paid to that country (or countries) without any recapture of the prior benefits from foreign losses (except in the case of foreign oil related losses, which were subject to recapture).

To reduce these advantages, the 1976 Act extended the recapture provisions to all foreign losses. The Act requires that, in cases where a loss from foreign operations reduces U.S. tax on U.S. source income, the loss is to be recaptured by the United States if the company subsequently derives income from abroad. In general, the recapture is accomplished by treating a portion of foreign income which is subsequently derived as income from domestic sources.

The loss recapture provisions apply to losses sustained in taxable years beginning after December 31, 1975. An exception to the effective date is provided for cases where a loss sustained in 1976 is from an investment in a corporation which became substantially worthless prior to the effective date. This exception applies where a corporation has suffered an operating loss in three out of the five years preceding the year in which the loss was sustained, the corporation has sustained an overall loss for those five years, and the termination of the investment takes place before January 1, 1977.

An additional exception was provided for cases where an investment is continued beyond 1976 in an attempt to try to make the investment profitable, although the attempt may ultimately fail. The Act provides that if a loss would qualify for the above exception to recapture but for the fact that the investment was not terminated in 1976, and if the investment is terminated before January 1, 1979, there is to be no recapture of the loss to the extent there was on December 31, 1975, a deficit in earnings and profits.

### ***Reasons for change***

A problem has arisen under the exception relating to deficits in earnings and profits prior to 1976 in that the Act requires that the deficit be computed with respect to all years of the corporation. However, in the case of a taxpayer who purchased a previously existing foreign corporation, the earnings and profits record for the years prior to the acquisition may not be available. Moreover, any losses (or profits) of the corporation prior to its acquisition by the U.S. taxpayer are not necessarily relevant to the taxpayer's loss upon later sale of that corporation, since the price paid by the U.S. taxpayer presumably reflects the accumulated earnings and profits (or any deficit) prior to the date of acquisition.

In addition, problems can arise for U.S. taxpayers owning foreign corporations prior to 1962 because, unless dividends are likely to be paid out of pre-1962 earnings, the corporation may not have retained earnings and profits records from pre-1962 years.

### ***Explanation of provision***

The Act modifies the exception to the recapture rules for substantially worthless investments disposed of after 1976 and before 1979. Under the bill, in computing the December 31, 1975, deficit in earnings and profits, there is only to be taken into account earnings or deficits of years after 1962 and then only to the extent that the taxpayer held the stock of the substantially worthless corporation in those

years. This period would include any tacked-on holding period under section 1223.

### ***Effective date***

The provision applies to taxable years after December 31, 1975.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million over the next several years.

### ***f. Transitional rule for recapture of possessions source losses (sec. 701(u)(7)(B) of the Act and sec. 1032 of the 1976 Act)***

#### ***Prior law***

Prior to the Tax Reform Act of 1976, foreign losses of a taxpayer electing the per country limitation on the foreign tax credit could be used to reduce U.S. tax on U.S. income in the year of the loss. In subsequent years when income is earned in that foreign country, little or no U.S. tax arose because of foreign taxes allowed as credits against that income.

The 1976 Act repealed the per country limitation for years beginning with 1976 and, in addition, provided that any foreign losses on an overall basis are to be recaptured out of future foreign income.

However, the Act provided a three-year exception (i.e., up to 1979) to the repeal of the per country limitation for income from sources within a possession of the United States (including Puerto Rico). No similar exception was provided for the loss recapture rule, but any losses reducing U.S. tax under the per country limitation during the 3-year period are only to be recaptured on a per country basis.

#### ***Reasons for change***

In the conference relating to the Tax Reform Act of 1976, the conferees had agreed to adopt an exception to the loss recapture rules for losses arising in the possessions through 1978. However, the provision was inadvertently omitted from the conference report and the final legislation as enacted.

#### ***Explanation of provision***

The provision creates an exception to the loss recapture rule for possession source income for taxpayers using the per country limitation. Under the exception, losses from the possessions arising in years before 1979 generally would not be subject to recapture where those losses are attributable to a trade or business which was conducted in the possessions before 1976. However, losses from possessions sources incurred during the pre-1979 transition period would, nevertheless, be subject to recapture in years after 1978 to the limited extent that affiliates of the taxpayer earn possessions source income during those years which is not included in the consolidated return (for example, income earned by an affiliated corporation making an election under sec. 936). The Act makes it clear that losses which do not qualify for the limited exception to the recapture rules because they are not attributable to a trade or business engaged in by the taxpayer in the possession since 1975 are subject to recapture on a per-country basis only if (1) they credited rather than deducted foreign taxes in the year the loss arose and (2) the transitional per-country limitation for possessions applied to that year.



***Effective date***

The provision is effective upon enactment.

***Revenue effect***

This provision will reduce budget receipts by approximately \$2 million in fiscal year 1978. It is not likely to have any additional revenue effect until 1980, after which time there is some possibility that it could decrease budget receipts by up to \$10 million.

***g. Transitional per-country rules for certain mining companies (sec. 701(u)(6) of the Act and sec. 904 of the Code)******Prior law***

Under the 1976 Act, the per-country limitation could be used by certain mining companies with respect to foreign mining income for a 3-year transitional period (i.e., taxable years beginning before January 1, 1979). The transitional rule provides also that any losses sustained by the mining companies would be recaptured on a per-country basis against income subsequently earned in the country where the loss was sustained. However, the transitional rule as drafted would require losses sustained by all qualifying mining companies during the 3-year transition period to be recaptured on a per-country basis even in those cases where, with respect to the year of the loss, the taxpayer elects to use the overall limitation rather than the transitional per-country limitation.

***Reasons for change***

The transition rule applying per-country recapture for mining companies was intended to apply only where the company is on the per-country limitation for foreign tax credit purposes.

***Explanation of provision***

The Act amends the per-country transitional rule so that foreign mining losses sustained during the transition period will be recaptured on a per-country basis only if the transitional per-country limitation applied to the year in which the loss is sustained.

***Effective date***

This provision is effective upon enactment.

***Revenue effect***

This provision will increase budget receipts by less than \$1 million per year.

***h. Limitation on credits for foreign taxes on oil and gas extraction income earned by individuals (sec. 701(u)(8) of the Act and sec. 907 of the Code)******Prior law***

The 1976 Act made several modifications with respect to the limitations on credits for foreign taxes paid on oil and gas extraction income. In the case of corporations, the limitation on extraction taxes was reduced to 48 percent, the maximum tax which the U.S. would impose on such income. However, in the case of noncorporate taxpayers, it was felt that the 48-percent limitation was not appropriate because foreign extraction taxes should be allowed as creditable taxes to the extent of the effective U.S. tax rate on the extraction income

and noncorporate taxpayers could be subject to U.S. tax on that income at average rates in excess of the corporate rates.

The change in the extraction limit in the case of noncorporate taxpayers was accomplished by eliminating the separate limitations for oil related income and the fixed percentage limitation on the extraction taxes of noncorporate taxpayers and by substituting a separate foreign tax credit limitation for foreign oil and gas extraction income. Thus, the limitation on extraction taxes paid by noncorporate taxpayers is an amount equal to the taxpayer's effective U.S. rate of tax (before foreign tax credit) times the taxpayer's foreign extraction income.

### ***Reasons for change***

Although this change effectively accomplishes the intended goal of allowing credits for extraction taxes paid by noncorporate taxpayers up to the amount of the pre-credit U.S. tax on the extraction income, it also has certain unintended additional effects. First, the change operates to allow noncorporate taxpayers full carrybacks and carryovers of all excess extraction taxes, rather than limiting the excess credits which can be carried from a year to 2 percent of extraction income (as in the case of corporations). In addition, it allows noncorporate taxpayers to use extraction losses arising in a country to reduce foreign income which is not oil extraction income and then to reduce U.S. source income, rather than requiring that such losses first reduce foreign oil extraction income earned in other countries.

### ***Explanation of provision***

The Act retains as the limit on credits for extraction taxes paid by noncorporate taxpayers their pre-credit U.S. tax on extraction income, but it also conforms the treatment of extraction taxes for noncorporate taxpayers to the treatment afforded corporate taxpayers by imposing the separate limitation for foreign oil related income and limiting the excess credits which can be carried from a year to 2 percent of extraction income.

### ***Effective date***

The provision applies to taxable years ending after December 31, 1974.

### ***Revenue effect***

This provision will increase budget receipts by less than \$5 million per year.

### ***i. Foreign taxes attributable to section 911 exclusion (sec. 701(u) (10) of the Act and sec. 911 of the Code)***

#### ***Prior law***

The 1976 Act made several modifications to the section 911 exclusion for earned income of U.S. citizens working abroad. One of the 1976 Act modifications was to disallow as a credit or deduction those foreign taxes attributable to income which is excluded from U.S. tax. This provision was intended to prevent a double benefit where a taxpayer had a certain amount of his income excluded from tax and, in addition, was able to use any foreign taxes paid on that income to reduce or eliminate U.S. tax on other income.

### ***Reasons for change***

The 1976 Act does not specify how the amount of taxes attributable to excluded income is to be determined in cases where the taxpayer has additional foreign income from the same country in which the excluded income is earned. Consequently, difficulties can arise in coordinating the appropriate disallowance of foreign tax credits with the rules (of sec. 911(d)) determining the U.S. tax treatment of any additional foreign income.

### ***Explanation of provision***

The Act specifies the manner in which foreign taxes are to be determined attributable to excluded income and thus disallowed as foreign tax credits. The amount of foreign taxes disallowed is determined by multiplying the amount of the foreign taxes paid by a fraction the numerator of which is the U.S. tax on the excluded amount (plus the applicable zero bracket amount) and the denominator of which is the sum of the numerator plus the foreign tax credit limitation for the year. Under this method, taxes are generally disallowed in the proportion that the tax on the excluded amount bears to the amount of U.S. tax which would be imposed on an amount of taxable income equal to foreign source income (thereby allocating foreign taxes between excluded and nonexcluded foreign source income in proportion to the U.S. progressive tax rate schedule). Where a taxpayer has U.S. source income, the amount of taxes disallowed is somewhat less because the average U.S. effective rate is applied to the nonexcluded foreign source income. However, this method greatly simplifies the calculation because it uses figures that are line items on the return which the taxpayer must compute in any event for other purposes.

### ***Effective date***

The provision applies to taxable years beginning after December 31, 1975, the general effective date of the 1976 Act amendments to sec. 911 of the Code. However, since the Tax Reduction and Simplification Act of 1977 deferred the 1976 Act amendments until taxable years beginning in 1977, the provision in the Act will not be effective before that time.<sup>1</sup>

### ***Revenue effect***

This provision has no effect on budget receipts.

### ***j. Gain on disposition of stock in a DISC (sec. 701(u)(12) of the Act and sec. 995 of the Code)***

#### ***Prior law***

Prior to the 1976 Act, there was no recapture of accumulated DISC income (i.e., treatment as a dividend) on the distribution of DISC stock in certain tax-free transactions (sec. 311, 336, or 337) because no gain was recognized on the transfer. The accumulated DISC income would

<sup>1</sup> Section 4 of the Foreign Earned Income Act of 1978 deferred the effective date of the amendments to section 911 until taxable years beginning in 1978, and section 202(a) of the Foreign Earned Income Act of 1978 amended section 911(a) so as to repeal the amendment made by this section generally for taxable years beginning after 1977. Thus, the amendment made by this section will apply only to those taxpayers who elect, pursuant to section 209(c) of the Foreign Earned Income Act of 1978, to not have amendments made by that Act apply for 1978.

also escape recapture upon a subsequent disposition of the DISC stock by the distributee if the distributee did not carry over the distributing corporation's basis and holding period in the DISC stock (but instead received a stepped-up basis). Therefore, the 1976 Act requires recapture of the accumulated DISC income upon a distribution, sale, or exchange of DISC stock to which section 311, 336, or 337 of the Code applies. (Sec. 995(c)(1)(C))

The amendments by the 1976 Act were effective for sales or other dispositions made after December 31, 1975, in taxable years ending after that date.

### ***Reasons for change***

In certain transactions to which sections 311, 336, or 337 apply where the stock of a DISC is transferred from one member to another member of the same controlled group, the distributee does not receive a step-up in basis for the distributed stock, but rather receives a carry-over basis. In those instances where the distributee receives a carry-over basis, the holding period of the distributing corporation is tacked on to the holding period of the distributee (sec. 1223(2)). Because there is a carryover of basis and holding period in these situations, there is no possibility for the avoidance of the recognition of accumulated DISC income upon the subsequent disposition of such stock by the distributee. Consequently, there is no need to recapture the DISC benefits in these instances.

In addition, this recapture provision was not contained in the House version of the 1976 Act but was added to the Act as part of the Senate amendment to the DISC provisions, which generally were effective for sales after December 31, 1976. The conference committee adopted the substantive provisions of the Senate amendment, but with the December 31, 1975, effective date of the House bill. The use of the House bill's December 31, 1975, effective date results in the application of the Senate's recapture rule to transactions occurring during 1976 when the taxpayers did not have notice that the recapture provision would apply.

### ***Explanation of provision***

The Act makes the 1976 Act amendment inapplicable to those situations where the distributee of the DISC stock receives both a carryover basis and a tacked on holding period. Thus, for example, in a liquidation of a subsidiary to which section 334(b)(1) applies (in which the basis and the holding period of property distributed by a subsidiary is carried over to its parent), recapture on the distribution of DISC stock would not be required.

The Act also delays the effective date of the DISC recapture provision of the 1976 Act until December 31, 1976.

### ***Effective date***

The provision is effective as if it were included in the Tax Reform Act of 1976.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

***k. Limitation on partner's tax where partner is treated as having sold or exchanged section 1248 stock (sec. 701(u)(13) of the Act and sec. 751 of the Code)***

***Prior law***

The 1976 Act provides that if a partnership holds stock in a foreign corporation which would be subject to dividend treatment (under sec. 1248) if sold or exchanged, any gains to a partner receiving certain partnership distributions or selling his interest in the partnership will be treated as ordinary income to the extent that he would have had a dividend had the foreign corporate stock been sold.

***Reasons for change***

The dividend treatment rules on foreign corporate stock include a specific limitation applicable to individuals (sec. 1248(b)) under which the individual's U.S. tax is limited to (1) his share of any additional tax that would have been payable if the foreign corporation had been a domestic corporation paying tax at the full United States corporate rate plus (2) the capital gains tax for which the individual would be liable on an amount equal to his share of the after-tax earnings and profits (assuming the full U.S. tax rate) of the corporation. The provision in the 1976 Act applying the dividend treatment rules to the partnership area did not include this special limitation relating to individuals. This could have the impact of requiring individuals holding stock in a foreign corporation to pay a substantially greater tax in cases where they sell their interest in the partnership than in cases where they sell the stock directly. The Congress believes this was an unintended difference.

***Explanation of provision***

The Act modifies the provision in the Code (sec. 751) which treats certain gains to a partner as an unrealized receivable to the extent the amounts would be treated as gain to which the foreign corporation dividend rules (sec. 1248) would apply. The modification provides that, in the case of an individual, the tax attributable to the sec. 1248 amount is to be limited in the same manner as it would be limited (under sec. 1248(b)) had the stock in the foreign corporation been sold by the individual or partnership.

***Effective date***

The provision applies to transfers beginning after October 9, 1975, and to sales, exchanges, and distributions taking place after that date.

***Revenue effect***

This provision will reduce the budget receipts by less than \$1 million per year.

***l. Excise tax on transfers of appreciated assets to foreign entities (sec. 701(u)(14) of the Act and sec. 1491 of the Code)***

***Prior law***

An excise tax (sec. 1491) is imposed upon the transfer of certain appreciated property to foreign entities. The tax applies to citizens or residents of the United States and to domestic corporations, partnerships, and trusts. Under prior law, it did not apply to estates because the basis of assets transferred at death was "stepped-up" to their

fair market value on the date of death (or alternative valuation date where applicable).

The 1976 Act increased the excise tax and expanded the application of the tax to additional types of property. In addition, the Act provided a carryover basis for assets transferred at death. Since assets transferred by estates do not generally receive a step-up in basis, assets transferred by estates to foreign entities can escape both the U.S. capital gains and excise taxes.

The 1976 Act also provides that the excise tax imposed on transfers of property to foreign persons to avoid Federal income tax shall not apply to "a transfer to which section 367 applies". In these instances, the taxation of such transfers are governed by section 367.

### ***Reasons for change***

As a result of the 1976 Act changes providing for carryover basis at death, estates can avoid U.S. income tax on transfers of appreciated assets to foreign entities. The Congress believes that the excise tax should apply to these types of transfers to prevent any tax advantage.

In addition, the exception created in the 1976 Act for transfers to which section 367 applies produces some possibility that specific transfers to which that section does not apply because the IRS has determined that no tax avoidance is involved will inadvertently be subjected to the excise tax.

### ***Explanation of provision***

The Act extends the excise tax on transfers of property to foreign entities to transfers made by estates subject to U.S. tax. In addition, it extends the tax to transfers of appreciated property by U.S. persons to foreign estates.

The Act also provides that the excise tax does not apply to "a transfer described in section 367." As a result of this amendment, transfers of property described in section 367, although excepted from its application under section 367(a)(2), will not be subject to the excise tax imposed under section 1491.

### ***Effective date***

The provisions apply to transfers made after October 2, 1975.

### ***Revenue effect***

This provision will increase budget receipts by less than \$1 million per year.

***m. Income tax treatment of nonresident alien individuals who are married to citizens or residents of the United States (secs. 701(u)(15) and (16) of the Act and sec. 6013(g) and (h) of the Code)***

### ***Prior law***

The 1976 Act permits a nonresident alien individual who is married to a citizen or resident of the United States to file a joint return provided that both spouses elect to be taxed on their worldwide income. Sections 6013 (g) and (h), as added by the Act, both provide that the nonresident alien individual in question "shall be treated as a resident

of the United States for purposes of chapter 1 for all of such taxable year."

In addition, the Act provides that the election to be treated as a resident will apply to any individual who, at the time an election was made, was a nonresident alien individual married to a citizen or resident of the United States. A literal reading of this provision results in a requirement that, at the time the election is made, one of the spouses must be a nonresident alien married to a U.S. citizen or resident.

### ***Reasons for change***

By referring only to chapter 1 of the Code, a nonresident alien qualifying under section 6013 (g) or (h) will be treated as a U.S. resident for joint return purposes, but as a nonresident alien for purposes of the excise tax on transfers of property to a foreign person (chapter 5) and for wage withholding purposes (chapter 24).

An additional problem arises because of the possible interpretation that the nonresident alien electing to file a joint return must be a nonresident at the time the election is made (i.e., at the time the return is filed). This requirement appears inappropriate where the nonresident becomes a resident of the United States in the period between the year in question and the time for filing the return for that year.

### ***Explanation of provision***

The Act provides that nonresident aliens electing under section 6013 (g) or (h) will be treated as U.S. residents for purposes of chapters 5 and 24, as well as chapter 1. It is contemplated that nonresident aliens electing under section 6013 (g) or (h) will be treated as resident aliens under the procedural and administrative provisions of Subtitle F where those provisions relate to the treatment of the taxpayer under chapter 1, 5, or 24. In addition, the Act provides that a refund will be allowed for any overpayment of tax attributable to withholding taxes imposed (under sec. 1441) on income of an electing nonresident alien for a year with respect to which the election applies.

The Act also deletes the requirement that one spouse be a nonresident alien married to a U.S. citizen or resident at the time of the election and provides instead that it applies to nonresident aliens who, at the close of the taxable year with respect to which an election is made, are married to U.S. citizens or residents.

### ***Effective date***

The provisions making the election effective for all purposes of chapters 5 and 24 (and related administrative provisions) and clarifying the time with respect to which the individual making the election must be a nonresident alien are effective for taxable years ending on or after December 31, 1975 (the effective date of the 1976 Act provisions). The provisions relating to wage withholding (chapter 24 of the Code) are to apply to remuneration paid on or after March 1, 1979.

### ***Revenue effect***

This provision has no effect on budget receipts.

***n. Foreign tax credit for production-sharing contracts (sec. 701(u)(9) of the Act and sec. 1035(c) of the Tax Reform Act of 1976)***

***Prior law***

An IRS ruling (Rev. Rul. 76-215, 1976-1 CB 194) holds that a contractor operating under a production-sharing contract in Indonesia is not entitled to a foreign tax credit for payments made by the government-owned company to Indonesia which contractually satisfy the contractor's liability. The IRS announced that this ruling would only apply prospectively to credits claimed for taxes paid in taxable years beginning on or after June 30, 1976.

Apparently the Indonesian taxes affected by the ruling are imposed on an annual basis, and in most situations the entire annual tax liability accrues on December 31 with respect to each year. Consequently, the ruling did not affect the creditability of Indonesian taxes paid and accrued with respect to 1976 by calendar year taxpayers and taxpayers whose fiscal year began before June 30, 1976. With respect to taxpayers whose fiscal year began on or after June 30, the ruling applied to the fiscal year beginning in 1976 and ending in 1977, and therefore disallowed the creditability of Indonesian taxes imposed with respect to 1976.

The 1976 Act provides that Revenue Ruling 76-215 is not to apply to most taxpayers for taxable years ending in 1977 with respect to amounts paid to foreign governments and designated as taxes under production-sharing contracts entered into before April 8, 1976. The 1976 Act generally intended to delay the effect of the ruling for one year so that the companies would have additional time to renegotiate their production-sharing contracts with Indonesia. The Act does result in a one-year delay in the effective date of the ruling for taxpayers on a calendar year basis (for taxes paid with respect to 1977) and for taxpayers with fiscal years beginning on or after June 30 (for Indonesian taxes paid with respect to 1976). In the case of taxpayers with fiscal years beginning before June 30, however, the Act does not delay the date of the ruling (to cover Indonesia taxes paid with respect to 1977).

***Reasons for change***

The result of Revenue Ruling 76-215 and the 1976 Act is that calendar year taxpayers are permitted to treat their payments made with respect to 1977 as creditable taxes while fiscal year taxpayers can only credit payments made through 1976. This creates inequities for fiscal year taxpayers.

***Explanation of provision***

The Act delays the effect of the revenue ruling so that all amounts paid or accrued to the foreign government before January 1, 1978, and attributable to income earned before that date would be creditable (thus allowing the credit for amounts paid to Indonesia in 1977 by fiscal year taxpayers).

***Effective date***

The provision is effective upon enactment.



### ***Revenue effect***

This provision will reduce budget receipts by \$5 million in fiscal year 1978 only.

### ***o. Source of income on liquidation of foreign corporation (sec. 701(u)(2)(C) of the Act and sec. 904(b) of the Code)***

#### ***Prior law***

Generally, the source of income derived from the sale of personal property, including stock, is determined by the place of the sale. However, the 1976 Act provided as a general rule, that gain on the sale or exchange of personal property outside the U.S. which is not subject to a foreign tax of at least 10 percent will not be considered foreign source income. That general rule does not apply in certain specific situations including, in the case of a sale by a corporation of stock in a second corporation, those where the stock is sold in a country in which the second corporation derived more than 50 percent of its gross income. The provision was intended to prevent taxpayers from maximizing the use of foreign tax credits by arranging for sales of personal property to take place in low tax foreign countries.

#### ***Reasons for change***

The 1976 Act provision applies to liquidations as well as to other types of exchanges. However, the potential for artificially arranging a sale in a low-tax country does not exist in the case of liquidations because, under the normal source rules, any gain from a liquidation has its source in the country of incorporation. Consequently, the need to recharacterize any income resulting from a liquidation as domestic source income is limited to cases where the corporation is incorporated abroad but doing most of its business within the United States.

#### ***Explanation of provision***

The Act provides that the source of income received by a corporation on the liquidation of a foreign corporation will be treated as foreign source income in all cases, except where the foreign corporation derived 50 percent or more of its gross income from U.S. sources for the 3-year period ending with the close of its taxable year immediately preceding the year in which the liquidation occurs.

#### ***Effective date***

The provision applies to taxable years beginning after December 31, 1975.

### ***Revenue effect***

The provision will reduce budget receipts by less than \$5 million per year.

## **22. Gain From Sales Between Related Persons (sec. 701(v) of the Act and sec. 1239(a) of the Code)**

### ***Prior law***

Under present law, gain from sales or exchanges between certain related persons is treated as ordinary income. The 1976 Act expanded the application of this provision (sec. 1239) to include sales or exchanges between commonly-controlled corporations and to determine stock ownership by reference to the attribution rules generally applicable to corporations and shareholders (sec. 318).

In making these changes, the 1976 Act inadvertently changed the description of the property subject to the provision from "property of a character which is subject to the allowance for depreciation provided in section 167" to property which is "subject to the allowance for depreciation provided in section 167." However, no substantive change was intended by this change in language.

### ***Reasons for change***

In order to prevent the possibility of any misinterpretation, the Congress believes that it is appropriate to reinstate the language previously used in section 1239, i.e., "property of a character which is subject to the allowance for depreciation provided in section 167."

### ***Explanation of provision***

The Act amends section 1239(a) of the Code by deleting the language "subject to the allowance for depreciation provided in section 167" and substituting the language "property of a character which is subject to the allowance for depreciation provided in section 167." No substantive change in the law is intended by this change in language.

### ***Effective date***

The amendment made by this section is applicable to sales or exchanges after October 4, 1976 (the date of enactment of the 1976 Act). A sale or exchange is considered to have occurred on or before October 4, 1976 if it is made pursuant to a binding contract entered into on or before that date.

### ***Revenue effect***

This provision has no effect on budget receipts.

### **23. Recapture of Depreciation on Player Contracts (sec. 701(w) of the Act and sec. 1245 of the Code)**

#### ***Prior law***

The 1976 Act provided special rules for recapture of depreciation and deductions for losses taken with respect to player contracts. The special recapture rules apply only in the case of the sale, exchange, or other disposition (other than a disposition under which the transferee has a carryover basis) of the entire sports franchise. In the case of the sale or exchange of individual player contracts, the amount recaptured as ordinary income is determined on a contract-by-contract basis. Under the special recapture rules for sales of the entire franchise, the amount recaptured as ordinary income is the amount of gain not to exceed the greater of (1) the sum of the depreciation taken plus any deductions taken for losses (i.e., abandonment losses) with respect to those player contracts which are initially acquired as a part of the original acquisition of the franchise or (2) the amount of depreciation taken with respect to those player contracts which are owned by the seller at the time of the sale of the sports franchise. Under the provision, the potential recapture amounts for both the initial contracts and the contracts transferred in connection with the sale of the franchise are reduced by amounts previously recaptured with respect to the applicable contracts.

The special recapture rules provisions apply to transfers of player contracts in connection with any sale or exchange of a franchise after December 31, 1975.

#### ***Reasons for change***

Since there could be no prior disposition of a contract held at the time the entire franchise is transferred, the reduction for prior recapture amounts for these contracts is unnecessary.

In addition, the special recapture rules for the initial contract recapture pool result in retroactively changing the treatment of depreciation and losses claimed before 1976 if the franchise is sold after December 31, 1975.

#### ***Explanation of provision***

Under the Act, the provision for a reduction for prior recapture amounts attributable to contracts actually transferred with the sale or exchange of a sports franchise is deleted.

The Act also provides that the pool recapture rule for contracts initially acquired with the franchise is to apply with respect to depreciation allowable for periods after December 31, 1975, and losses incurred after December 31, 1975.

#### ***Effective date***

The amendments apply to transfers of player contracts in connection with a sale or exchange of a franchise after December 31, 1975.

***Revenue effect***

The provision relating to recapture amounts for contracts actually transferred with the sale or exchange of a sports franchise has no effect on budget receipts. The provision relating to the effective date of the special recapture rules will reduce budget receipts by \$1 million in fiscal 1978 and by less than \$1 million each fiscal year thereafter.

## **24. Treatment of Pensions and Annuities for Purposes of Maximum Tax on Personal Service Income (sec. 701(x) of the Act and sec. 1348 of the Code)**

### ***Prior law***

The Tax Reform Act of 1976 amended the 50-percent maximum tax on personal service income to provide, in part, that amounts received as a pension or annuity were treated as personal service income (subject to certain special exceptions). However, that Act did not specifically limit the application of the maximum tax to pensions or annuities which are connected with earning income from personal services.

### ***Reasons for change***

Presently, it is unclear if the maximum tax applies to pensions or annuities which do not arise from an employer-employee relationship or from tax deductible contributions to a retirement plan. Congress intended that the maximum tax apply to amounts received as a pension or annuity only when the pension or annuity arises from a situation where personal services were rendered either as an employee or as a self-employed person.

### ***Explanation of provision***

The Act clarifies present law by providing that the 50 percent maximum tax applies to a pension or annuity only when the pension or annuity arises from a situation where personal services were rendered either as an employee or as a self-employed person (such as an independent contractor). This clarification applies to pensions and annuities established by an employer for his employee (whether or not made under a qualified pension plan) and to amounts received from H.R. 10 plans and individual retirement accounts, annuities, and bonds. Pensions or annuities that are not connected with earned income from personal services do not qualify. However, this amendment is not intended to deny the benefits of the maximum tax provisions to other deferred compensation arrangements where the compensation is "earned income" within the meaning of section 911(b), i.e., wages, salaries, professional fees, and other amounts received for personal services. For example, payments to a retired partner where the payments are for personal services actually performed prior to retirement are eligible for the 50-percent maximum tax rate (except to the extent that capital is a material income-producing factor).<sup>1</sup>

### ***Effective date***

The provision applies to taxable years beginning after December 31, 1976.

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<sup>1</sup> These payments would be eligible for the maximum tax rate because they are defined as earned income under section 911(b) although, under section 911(c) (5), no foreign source income exclusion is allowed under section 911(a) for deferred compensation.

***Revenue effect***

The provision will increase budget receipts by less than \$1 million per year.

## **25. Certain Grantor Trusts Treated as Permitted Shareholders of Subchapter S Corporations (sec. 701(y) of the Act and sec. 1371 of the Code)**

### ***Prior law***

Prior to the 1976 Act, a corporation could not elect to be treated as a subchapter S corporation if it had a trust as a shareholder. However, an estate was permitted to be a shareholder. Under the (1976 Act, a so-called "grantor trust" is permitted to be a shareholder of a subchapter S corporation. In addition, the 1976 Act permitted a testamentary trust to be a shareholder in a subchapter S corporation for 60 days. However, the 60-day period was not extended to a grantor trust following the grantor's death although, in many cases, the trust is used as a will substitute.

### ***Reasons for change***

The Congress believes that a grantor trust should be permitted to be a shareholder of a subchapter S corporation for two years after the death of the grantor, since this type of trust is often used as a will substitute and should be treated in a manner similar to an estate.

However, where the corpus of the trust is not includible in the estate, only 60 days should be allowed. In addition, the Congress wishes to clarify that the grantor of a grantor trust must himself be an eligible shareholder for the trust to qualify.

### ***Explanation of provision***

The provision amends the qualification requirements for subchapter S treatment to permit a grantor trust to be an eligible shareholder for a two-year period following the grantor's death if the entire corpus of the trust is includible in the grantor's gross estate. If the entire corpus is not included in the grantor's estate, only 60 days are provided. The two-year period is roughly equivalent to a normal period of administration while the stock is held by the estate and a 60-day period after the testamentary trust receives the stock from the estate.

The provision also makes it clear that a grantor trust is an ineligible shareholder only if the grantor would be an eligible shareholder, i.e., the grantor is an individual citizen or resident of the United States.

### ***Effective date***

This provision is effective for taxable years beginning after December 31, 1976.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

**26. Withholding of Federal Taxes on Certain Individuals Engaged in Fishing (sec. 701(z) of the Act and secs. 1402(c), 3121(b)(20), and 3401(a) of the Code)**

***Prior law***

The Tax Reform Act of 1976 changed the prior law treatment of certain individuals engaged in fishing for payroll tax purposes. Prior to the 1976 Act, the Internal Revenue Service frequently treated members of a fishing boat crew as employees rather than as self-employed individuals. As a result, operators of the boats had to withhold taxes from the wages of crew members and also had to deduct and pay Social Security taxes.

Under the 1976 Act, members of a fishing boat crew are to be treated as self-employed persons for Federal withholding and social security tax purposes if their sole remuneration is a share of the boat's catch (or a share of the proceeds of the catch) or, in the case of an operation involving more than one boat, a share of the entire fleet's catch or its proceeds. For this rule to apply, the boats must normally have operating crews of less than 10 members.

Generally, the changes made by the 1976 Act are applicable to services performed after December 31, 1971.

***Reasons for change***

It has been brought to the attention of Congress that the provision enacted under the 1976 Act does not cover all open cases because of the effective date.

***Explanation of provision***

The Act would extend the treatment provided for crew members in the 1976 Act to all services performed after December 31, 1954.

***Effective date***

The provision is to apply to services performed after December 31, 1954.

***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.



## **27. Tax on Excess Individual Retirement Plan Contributions (sec. 701(aa) of the Act and sec. 4973(a) of the Code)**

### ***Prior law***

Under present law, deductible contributions by an individual for a taxable year to an Individual Retirement Account (IRA) are generally limited to the lesser of \$1,500 or 15 percent of earned income. The 1976 Act increased the dollar limitation to \$1,750 where contributions to the account are allocated equally between a spouse with earned income and a spouse with no earned income. If an amount in excess of the deductible amount is contributed, the owner of the IRA is subject to a 6-percent nondeductible excise tax on the excess for the year of contribution and each later year for which the excess remains in the account.<sup>1</sup> The 1976 Act also amended the excise tax provisions to provide that the tax on excess contributions would be imposed on the spouse to whom an IRA deduction is allowed (sec. 1501(b)(8)(A) of the 1976 Act and sec. 4973(a) of the Code). However, the deadwood provisions of the 1976 Act (sec. 1904(a)(22)) had the effect of repealing that amendment.

### ***Reasons for change***

The Congress believes that it is appropriate to make conforming change.

### ***Explanation of provision***

The Act provides for the imposition of the excise tax on the spouse who is allowed the deduction with respect to the contributions made to such account.

### ***Effective date***

This provision applies for taxable years beginning after December 31, 1976, the date the provision of the 1976 Act was intended to apply. However, section 157(j)(2) of the 1978 Act repeals this provision for contributions made for taxable years beginning after December 31, 1977.

### ***Revenue effect***

The provision has no effect on budget tax receipts.

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<sup>1</sup> If the contribution exceeds the 15-percent limit but not the applicable maximum dollar ceiling, the excise tax can be avoided if the excess is withdrawn before the end of the taxable year in which it was contributed.

## **28. Disclosure of Returns and Return Information (sec. 701(bb) of the Act and secs. 6103, 7213 and 7217 of the Code)**

### ***Prior law***

The 1976 Act significantly increased the confidentiality of returns and return information by restricting the instances in which returns or return information may be disclosed to those agencies and individuals enumerated in section 6103 of the Code.

The 1976 Act treats taxpayer return information, including the address supplied by the taxpayer on his or her tax return, as confidential information not subject to disclosure by the IRS, except as specified in the Act. While the Act provides for disclosure of address information in certain situations, no provision was made in the Act to permit the disclosure of the mailing address of persons who have defaulted on student loans made under part E of title 4 of the Higher Education Act of 1965.

Under the 1976 Act, the Justice Department and other Federal agencies are required in nontax criminal cases to obtain court approval in order to receive return information which was filed by or on behalf of a taxpayer with the IRS. The court approval procedure, however, does not apply to return information which is not furnished by or on behalf of the taxpayer. Thus, in nontax criminal cases, the IRS may disclose to the Justice Department or other Federal agency return information, other than that furnished by or on behalf of the taxpayer, including return information which may constitute evidence of a violation of the Federal criminal laws (secs. 6103 (i) (2) and (i) (3)). In order for the IRS to transmit this information to the Justice Department or other Federal agency, it is necessary, of course, to provide the name and address of the taxpayer. Because the taxpayer furnishes his name and address on his return, it is arguable that the IRS would not be able to provide this information to the Justice Department or other Federal agency, thus completely negating the purpose and operation of these provisions.

The 1976 Act provided that returns and return information relating to specified Federal taxes could generally be disclosed to State tax officials for the purpose of, but only to the extent necessary in, the administration of State tax laws. However, the 1976 Act omitted taxes imposed by chapter 31 of the Code (i.e., the special fuel excise taxes) from the list of taxes with respect to which information could be disclosed to State tax officials. As a result, the IRS no longer has the authority to provide State tax officials with returns or return information regarding special fuel excise taxes.

The 1976 Act provides that returns or return information may be disclosed to a competent authority of a foreign government which has an income tax treaty with the United States, but only to the extent provided in and subject to the terms and conditions of such treaty. No similar provision is made, however, with respect to estate and gift tax treaties.

Under the 1976 Act, the criminal violation of the disclosure rules is a felony punishable by a fine of up to \$5,000, or imprisonment of up to 5 years, or both. It is also a felony, subject to the same penalties, for any person to receive an unauthorized disclosure of returns or return information as a result of an offer by that person to exchange an item of material value for the unauthorized disclosure. The 1976 Act also provides that any person who knowingly or negligently discloses returns or return information in violation of the law is liable to the taxpayer for actual damages sustained plus court costs (but in no event less than \$1,000 liquidated damages with respect to each unauthorized disclosure).

### ***Reasons for change***

The Congress believes that it is important to permit the disclosure of address information to the Commissioner of Education and educational institutions, for the purpose of locating individuals who have defaulted in payment of student loans.

The Congress believes that fuel excise tax returns may be disclosed to State tax authorities and that the IRS should have the authority to make disclosures to the Justice Department and other Federal agencies of information not furnished by the taxpayer where the information involved constitutes evidence of a violation of the Federal criminal laws.

Finally, because of the possible criminal or civil liability which Government employees handling returns and return information might face in the event of an unauthorized disclosure, the Congress believes that certain clarifying changes should be made to the civil and criminal penalty provisions in order to eliminate any possible doubt as to their meaning.

### ***Explanation of provisions***

*Disclosure of mailing addresses to the Commissioner of Education and educational institutions (sec. 701(bb) (1) of the Act and sec. 6103 (m) (4) of the Code)*

Upon the receipt of a written request, the Secretary will be authorized to disclose to the Commissioner of Education the mailing address of any taxpayer who has defaulted on a loan made from a student loan fund established under part E of title IV of the Higher Education Act of 1965 for use only to locate the taxpayer for purposes of collecting the loan. Any mailing address received by the Commissioner of Education under this provision may, in turn, be disclosed by the Commissioner of Education to any educational institution with which he has an agreement under part E of title IV of the Higher Education Act of 1965. These addresses will only be disclosed to employees and agents of the educational institution whose duties relate to the collection of student loans and only for the purposes of locating and collecting the loans from the individuals who have defaulted on student loans made by the institution pursuant to this agreement.

*Disclosure to State tax authorities of returns and return information regarding special fuel excise taxes (sec. 701(bb) (2) of the Act and sec. 6103(d) of the Code)*

This amendment includes returns and return information regarding the special fuel excise taxes imposed under chapter 31 of the Code

among the returns and return information which the IRS is authorized to disclose to State tax officials.

*Disclosure of name and mailing address to the Justice Department and other Federal agencies (secs. 701(bb)(2) and (3) of the Act and secs. 6103(i)(2) and (3) of the Code)*

These amendments permit the IRS to transmit to the Justice Department and other Federal agencies the name and address of a taxpayer along with return information (including return information indicating the violation of a Federal criminal law) pertaining to, but not furnished by or on behalf of, the taxpayer.

*Disclosure under tax conventions (sec. 701(bb)(5) of the Act and sec. 6103(k)(4) of the Code)*

The Act authorizes the Secretary to disclose returns or return information to a competent authority of a foreign government which has an estate and gift tax convention with the United States or other convention relating to the exchange of tax information, but only to the extent provided in and subject to the terms and conditions of such convention.

*Criminal penalty for unauthorized disclosure of returns and return information (secs. 701(bb)(1) and (6) of the Act and sec. 7213 of the Code)*

The Code provision imposing criminal penalties for unauthorized disclosures, printings, publications, and solicitations (sec. 7213) is amended in two respects. First, any employee or agent of an educational institution receiving a taxpayer's address in regard to a defaulted student loan, who, in turn, makes a disclosure which is not authorized under section 6103, will be subject to the criminal penalties of section 7213.

Second, the section is clarified by explicitly providing that the criminal penalties of section 7213 are to apply only to willfully made disclosures, printings, publications, or solicitations, as the case may be. The term "willfully" relates to a voluntary, intentional violation of a known legal duty. See, *U.S. v. Pomponio*, 97 S. Ct. 22 (1976).

*Civil penalties for unauthorized disclosures (sec. 701(bb)(7) of the Act and sec. 7217 of the Code)*

The Code provision imposing civil penalties for knowing or negligent unauthorized disclosures of returns and return information (sec. 7217) is amended to provide that no liability for this penalty shall arise in the event of an unauthorized disclosure which results from a good faith, but erroneous, interpretation of section 6103 and the rules and regulations relating thereto.

**Effective date**

Except for the amendment under section 701(bb)(7), the amendments made by this provision are effective on January 1, 1977. The amendment under sec. 701(bb)(7) (relating to relief from civil penalty liability in certain circumstances) is to apply to disclosures made after the date of enactment of this Act (November, 1978).

**Revenue effect**

This provision has no effect on budget receipts.

## **29. Definition of Income Tax Return Preparer and Negotiation of Taxpayer Refund Check by Banks (sec. 701(cc) of the Act and secs. 6695 and 7701 of the Code)**

### ***Prior law***

The Tax Reform Act of 1976 expressly exempts a fiduciary of a trust or an estate from certain rules relating to income tax return preparers for returns or claims for refund prepared for that trust or estate. However, other persons who prepare returns in a fiduciary capacity are not specifically excepted from the rules (for example, certain conservators or guardians whose fiduciary responsibilities are similar to those of trustees or executors).

The 1976 Act also prohibits any tax return preparer from endorsing a refund check of any taxpayer whose return he prepared (except for subsequent endorsements by banks). A \$500 fine was provided for violation of this provision.

### ***Reasons for change***

Many persons prepare returns of taxpayers in their capacity as a guardian, conservator, or other fiduciary with respect to the taxpayer. Under the 1976 Act in this case, the person was considered a tax return preparer. However, it is not necessary for the tax return preparer provisions to apply because these persons and their employees are generally subject to the considerably higher standards imposed on fiduciaries under local law.

All of the requirements of the 1976 Act also apply to banks which are tax return preparers for their customers generally (i.e., in other than a fiduciary capacity). In this case, although the bank should be subject to the basic rules relating to income tax preparers, there is no need to apply the prohibition against check endorsements where the check is deposited by the bank to the taxpayer's own account.

### ***Explanation of provision***

The Act creates an exception from the definition of tax return preparer for any person who prepares as a fiduciary a return or claim for refund for another person. The exception is limited to those returns of taxpayers with respect to whom the preparer is a fiduciary and does not affect a tax return preparer's status with respect to returns of other taxpayers.

In addition, the Act permits banks (as defined in sec. 581 of the Code) to endorse and deposit a customer's tax refund check in full to the customer's account in any case where the customer's tax return was prepared by that bank without violation of the penalties relating to endorsement of taxpayers' refund checks by tax return preparers.

In addition, the Congress wished to clarify the application of the return preparer penalty. It is intended that if a preparer in good faith and with reasonable basis takes the position that a rule or regulation does not accurately reflect the Code and does not follow it, the preparer has not negligently or intentionally disregarded the rule or

regulation. This test shall be applied in the same manner as it is applied under section 6653(a) and the regulations thereunder (relating to disregard of rules and regulations by taxpayers). For example, if a preparer reasonably takes the position in good faith that a revenue ruling does not accurately reflect the Code, the preparation of a return or claim for refund by the preparer in conflict with the revenue ruling is not a negligent or intentional disregard of the revenue ruling. For purposes of section 6694(a), the view of the taxpayer concerning a rule or regulation is not material.

The Congress directed that the Internal Revenue Service shall reasonably interpret section 6694(a) according to the standards of section 6653(a) and in light of all the facts and circumstances of each case, taking into account any and all mitigating factors.

***Effective date***

The provisions apply to documents prepared after December 31, 1976, and to taxpayer refund checks issued with respect to returns prepared after December 31, 1976.

***Revenue effect***

This provision has no effect on budget receipts.

### **30. Declaratory Judgments—Revocation of Prior Determination (sec. 701(dd) of the Act and secs. 7428 and 7476 of the Code)**

#### ***Prior law***

In the 1974 pension Act (ERISA), Congress provided for declaratory judgments “in a case of actual controversy involving—(1) a determination by the Secretary with respect to the initial qualification *or continuing qualification* of a retirement plan \* \* \*.” (Emphasis supplied.)

The 1976 Act provided for declaratory judgments “in a case of an actual controversy involving—(1) a determination by the Secretary—(A) with respect to the initial qualification *or continuing qualification* of an organization as an organization described in section 501(c)(3) \* \* \*.” (Emphasis supplied.) Both the House and Senate committee reports on the 1976 Act stated that this statutory language, in both Acts, is intended to grant jurisdiction in cases where the Internal Revenue Service has concluded that a previously qualified organization has lost its preferred tax status.

On October 6, 1976, the Tax Court published an opinion (*Sheppard & Myers, Inc. v. Comm’r*, 67 T.C. 26) in which it held that the retirement plans declaratory judgment provisions do not apply to revocations of favorable determination letters. The Tax Court decision made no mention of the 1976 Act or of the committee reports on that Act.

#### ***Reasons for change***

The legislative history of ERISA and of the Tax Reform Act of 1976 clearly indicate that Congress intended the Tax Court to have jurisdiction over cases involving revocation of prior favorable determination by the IRS. However, in light of the recent *Sheppard & Myers Inc.* case, it appears that this intent should be expressed explicitly in the statute.

#### ***Explanation of provisions***

The Act makes clear that the declaratory judgment provisions relating to the qualification of retirement plans and relating to the status and classification of charitable organizations are to apply for revocations of any IRS determination in these areas.

#### ***Effective date***

Under the Act the provisions are to take effect as if included in the separate declaratory judgment provisions at the time those provisions were added to the Internal Revenue Code.

#### ***Revenue effect***

These provisions have no effect on budget receipts.

### **31. Contributions of Certain Government Publications (sec. 701 (ee) of the Act and sec. 1231 of the Code)**

#### ***Prior law***

Under present law, U.S. Government publications received from the Government without charge or below the price at which they are sold to the general public are not to be treated as capital assets either in the hands of the taxpayer so receiving the publications or in the hands of a taxpayer whose basis in such a publication is determined by reference to its basis in the hands of a person who received it free or at a reduced price.

#### ***Reasons for change***

Under the 1976 Act, these publications were excluded from the definition of "capital asset" under section 1221 of the Code. However, due to an oversight, they were not similarly excluded from the definition of "property used in the trade or business" under section 1231 (b) of the Code and, therefore, could still be eligible for capital gains treatment in certain circumstances.

#### ***Explanation of provision***

The Act corrects this technical error and amends section 1231 (b) to provide that the term "property used in the trade or business" does not include U.S. Government publications received from the Government without charge or below the price at which they are sold to the general public.

#### ***Effective date***

The provision applies to sales, exchanges, and contributions made after October 4, 1976.

#### ***Revenue effect***

This provision will involve a negligible increase in budget receipts.



### **32. Procedure for Claiming Exemption from Excise Tax on Certain Light-Duty Truck Parts (sec. 701(ff) of the Act and sec. 4063 of the Code)**

#### ***Prior law***

The 8-percent manufacturers excise tax on sales of truck parts or accessories does not apply to parts sold for "further manufacture." Consequently, when the 10-percent excise tax on light-duty trucks (10,000 pounds or less gross vehicle weight) was repealed in 1971, accessories sold by the manufacturer of such a truck on or in connection with the sale of the trucks were freed from all manufacturers excise tax. However, parts or accessories added to a light-duty truck by a dealer continued to be subject to the 8-percent tax if the addition of the part was not considered by the Treasury Department to be further manufacture. An example of this is the attachment of a bumper by a retail dealer to a new light-duty truck.

As a step toward equalizing the tax treatment of parts or accessories attached to new light-duty trucks, the Tax Reform Act of 1976 provided that the 8-percent excise tax on truck parts and accessories is refunded or credited to the manufacturer if the part or accessory is sold on or in connection with the first retail sale of a light-duty truck. The purpose of this provision is to remove the 8-percent excise tax on these parts and accessories sold on, or in connection with, the first retail sale of a light-duty truck. However, the excise tax still must be paid initially by the manufacturer, and the manufacturer may not claim credit or refund until after the retail sale of the vehicle.

#### ***Reasons for change***

It appears to the Congress that the manufacturer of the light-duty truck parts that are going to be eligible for the tax refund or credit under present law should be able to make the sales tax-free initially so that the manufacturer does not have to wait until the claim for refund or credit is made to have the tax removed.

#### ***Explanation of provision***

The Act permits the tax-free sale by the manufacturer, producer, or importer of any truck part which is to be resold by the purchaser on or in connection with the first retail sale of a light-duty truck (as described in sec. 4061(a)(2)) or is to be resold by the purchaser to a second purchaser for resale by the second purchaser on or in connection with the first retail sale of a light-duty truck. The Act also gives the Treasury Department authority to require registration of sellers and purchasers before they may engage in tax-free sales and purchases of the parts eligible for exemption from the 8-percent excise tax. The registration system is now required for most categories of sales that may be made free of the manufacturers excise taxes.

#### ***Effective date***

The provision is effective for sales of eligible light-duty truck parts and accessories made on or after December 1, 1978.

***Revenue effect***

This amendment is expected to have a negligible effect on budget receipts since it constitutes only a change in the administrative procedure for claiming the existing "exemption" for the eligible light-duty truck parts and accessories.

## **B. TECHNICAL AND CONFORMING AMENDMENTS TO ESTATE AND GIFT TAX PROVISIONS**

### **1. Application of "Fresh Start" Provisions to Section 306 Stock (sec. 702(a)(1) of the Act and sec. 306(a) of the Code)**

#### ***Prior law***

Under present law, special rules are provided to prevent the "bail out" of dividends as capital gains upon a sale or redemption of preferred stock previously distributed to shareholders. Under these rules, the amount realized from the sale or redemption of certain stock, known as "section 306 stock," is generally treated as dividend income. This treatment also applies to sales or redemptions of stock by a transferee if his basis is determined by reference to the basis of stock held by the transferor which was section 306 stock. Under the "stepped-up" basis rules in effect prior to the 1976 Act, inherited stock was not subject to dividend treatment under section 306 because the basis of the stock in the hands of his estate or his heirs was not determined by reference to the decedent's basis of the stock. However, under the carry-over basis provisions of the 1976 Act, the decedent's basis for the stock is carried over, with certain adjustments, to the estate or the heir. Thus, dividend treatment under section 306 also carries over from the decedent to his estate or heirs.

In the case of a redemption of section 306 stock, the full amount of the redemption proceeds are treated as dividend income to the extent of the corporation's earnings and profits at the time of the redemption.<sup>1</sup> In the case of a sale of section 306 stock, the amount realized is treated as ordinary income to the extent of the ratable portion of the corporation's earnings and profits on the date of distribution of the stock. In both cases, the "fresh start" adjustment to basis provisions of the 1976 Act has no effect on the amount of the dividend income because the basis of the stock is irrelevant in making that determination. However, amounts realized in excess of the sum of the applicable portion of earnings and profits and the basis of the stock is treated as gain from the sale of the stock. Thus, the "fresh start" provisions can affect the amount of gain on the sale or redemption of the section 306 stock but only when the amount realized exceeds the sum of the applicable portion of the corporation's earnings and profits and the stock's basis on December 31, 1976.

#### ***Reasons for change***

The adoption of the carryover basis provisions has the effect of changing the taxation of section 306 stock sold or redeemed after death. Unlike the situation under prior law, the death of the recipient

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<sup>1</sup> However, a distribution in redemption of section 306 stock to pay death taxes which qualifies under section 303 is treated as an amount realized from the sale or exchange of a capital asset rather than as dividend income. See sec. 306(b) (5) of the Code as added by sec. 702(a) (2) of the Act.

of section 306 stock no longer removes the section 306 taint. Moreover, due to the operation of the rules for section 306 stock (described above), the "fresh start" adjustment of the carryover basis provisions provides only limited relief because the amount of basis is rarely important in section 306 situations. Since the purpose of the "fresh start" rule was, generally, to "grandfather" appreciation occurring prior to December 31, 1976, the Congress believes that a special rule is needed to carry out this purpose in the case of section 306 stock which was issued before January 1, 1977.

### ***Explanation of provision***

The Act provides a special rule in the case of section 306 stock distributed before January 1, 1977, which is carryover basis property. However, under the Act, the special rule would apply only to stock passing or acquired from a decedent dying after December 31, 1979, in order to conform to the suspension of the carryover basis rules under section 515 of the Act. For stock passing or acquired from a decedent before January 1, 1980, it is unnecessary to provide any special rule because the basis of the stock will be stepped-up in the hands of the estate or heir and, therefore, will not be subject to dividend treatment under section 306.

Under the special rule for section 306 stock which is carryover basis property, the amount treated as ordinary income on the sale or redemption of the stock may not exceed the amount realized over the sum of the adjusted basis of the stock on December 31, 1976, and the "fresh start" adjustment under the carryover basis rules. In the case of a redemption, this special rule applies only with respect to a redemption which would be treated as a sale or exchange if the stock were not section 306 stock. Amounts not treated as ordinary income or as a dividend will be treated as recovery of basis or gain in accordance with the usual rules under section 306(a)(1) or 301(c), as the case may be.

### ***Effective date***

The provision is effective for section 306 stock distributed before January 1, 1977, which is acquired from a decedent dying after December 31, 1979.

### ***Revenue effect***

The 3-year suspension of carryover basis removes any revenue effect from this provision until fiscal 1981, when it would reduce budget receipts by less than \$1 million. It would reduce budget receipts by \$5 million in fiscal 1982, by \$7 million in fiscal 1983 and by gradually declining amounts through fiscal 1997 after which there is no revenue effect.

## **2. Redemptions of Certain Preferred Stock To Pay Death Taxes (sec. 702(a)(2) of the Act and sec. 306(b) of the Code)**

### ***Prior law***

Under present law (section 303), a distribution from a corporation to redeem its stock in order to pay death taxes and funeral and administration expenses is treated as an amount realized from the sale or exchange of a capital asset rather than as dividend (where certain requirements are met).

However, other provisions of the tax law (discussed above) are designed to prevent the "bail-out" of dividends as capital gain upon a sale or redemption of certain preferred stock distributed to shareholders. This stock is known as "section 306 stock." Because of the carryover basis provisions added by the 1976 Act, these special provisions apply to section 306 stock passing to the estate or heirs of the distributee shareholder.

It is presently unclear which of these two sets of rules takes precedence over the other; i.e., it is uncertain whether capital gains treatment is available for redemptions of section 306 stock when all of the requirements of section 303 are met with respect to the stock.

### ***Reasons for change***

The Congress believes that it should be made clear that redemptions of section 306 stock are eligible for capital gains treatment where the requirements for redemptions to pay death taxes and funeral and administration expenses (sec. 303) are met with respect to that stock. This treatment will facilitate the payment of death taxes and expenses and alleviate liquidity problems of estates consisting primarily of stock in closely held businesses.

### ***Explanation of provision***

The Act provides that a redemption of section 306 stock is excepted from dividend treatment to the extent that the redemption meets the requirements for capital gains treatment with respect to redemptions to pay death taxes and funeral and administration expenses (sec. 303). Accordingly, a distribution in a qualifying redemption of such stock is to be treated as an amount realized from the sale or exchange of a capital asset.

Under the Act, the provision would apply to stock passing or acquired from a decedent dying after December 31, 1979, in order to conform to the suspension of the carryover basis rules under section 515 of the Act. For stock passing or acquired from a decedent before January 1, 1980, it is unnecessary to provide any special rule because the basis of the stock will be stepped-up in the hands of the estate or heir and, therefore, will not be subject to dividend treatment under section 306.

***Effective date***

This provision is effective for redemptions of stock acquired from or passing from decedents dying after December 31, 1979.

***Revenue effect***

The 3-year suspension of carryover basis removes any revenue effect from this provision until fiscal 1981, when it would reduce budget receipts by less than \$1 million. It would reduce budget receipts by \$2 million in fiscal 1982 and by \$3 million in fiscal 1983.

### **3. Deduction or Adjustment to Basis for Estate Tax on Appreciation (sec. 702(b) of the Act and sec. 691 of the Code)**

#### ***Prior law***

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for Federal and State death taxes attributable to appreciation. This adjustment is designed to prevent the imposition of an income tax on the portion of the estate taxes attributable to appreciation. Similarly, when property has been sold before death but the gain is recognized by the heirs for income tax purposes (sec. 691), the recipient of the income is allowed a separate deduction for the death taxes attributable to that item of income in respect of a decedent (rather than as an adjustment to the basis of the property sold).

However, when the heir is entitled to long-term capital gain treatment, there may be a substantial disparity of treatment for income tax purposes between gains recognized by the heirs for property sold before death by the decedent and gains realized by the heirs upon a subsequent sale of inherited property. In the case of a sale before death, some courts have held that an individual is entitled to both the deduction for estate taxes attributable to the gain and the long-term capital gain deduction based on the amount of gain undiminished by the deduction for estate taxes.<sup>1</sup> However, in the case of a sale of inherited property by an heir, the basis adjustments for death taxes attributable to appreciation would be taken into account in determining the amount of gain to which the long-term capital gain deduction applies.

#### ***Reasons for change***

The Congress believes that capital gains recognized by heirs for property sold before death by the decedent should not be treated more favorably than gains realized by the heirs upon the sale of inherited property.

#### ***Explanation of provision***

The Act provides that, for purposes of computing the long-term capital gains deduction (or the amount of gain for purposes of the long-term capital gains alternative tax and any net capital losses), the amount of the gain is to be reduced (but not below zero) by the amount of any applicable deduction for estate taxes attributable to a gain treated as income in respect of a decedent. For example, if a long-term capital gain of \$100 is treated as income in respect of a decedent and the estate tax attributable to that gain is \$30, the amount of the recipient's long-term capital gain which is subject to the alternative tax on capital gains would be \$70 (\$100 minus \$30). In addition, the

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<sup>1</sup> It is possible that the combined deduction for estate taxes attributable to the income in respect of a decedent (up to 70 percent) and the capital gains deduction (60 percent) can exceed the amount of the capital gain and can be used to offset other ordinary income of the taxpayer.

amount of the long-term capital gains deduction would be \$42 (60 percent of \$70) for all purposes (including the minimum tax). In either case, no additional deduction would be allowed for the estate taxes attributable to that gain.

No inference is to be drawn from the amendment as to the correct interpretation of prior law.

***Effective date***

The provision is effective with respect to decedents dying after the date of enactment.

***Revenue effect***

This provision will increase budget receipts by less than \$5 million per year.



#### **4. Conforming Amendments to the Postponement of Effective Date of Carryover Basis Provisions (sec. 702(c)(1) of the Act and secs. 1014 and 2614 of the Code)**

##### ***Prior law***

Under the 1976 Act, the basis of property passing from a decedent is "carried over" from the decedent to the estate or beneficiaries for purposes of determining gain or loss for sales and exchanges by the estate or beneficiaries. Under prior law, the basis of inherited property was generally stepped up or down to its value on the date of the decedent's death. Under the 1976 Act, the carryover basis provisions apply to property passing from decedents dying after December 31, 1976. However, section 515 of the Revenue Act of 1978 delayed the effective date of the carryover basis provisions so as to apply only to property of decedents dying after 1979.

##### ***Reasons for change***

These changes are made in order to provide rules to conform certain provisions to the deferral of the effective date of carryover basis.

##### ***Explanation of provision***

Since the basis of farm and closely held business real property will not be carried over from the decedent during the 3-year deferral period, the Act provides that the basis of that real property will be the amount determined under the special valuation provision if elected for estate tax purposes rather than fair market value based on its highest and best use.

As a conforming change, the basis of property included in a generation-skipping transfer which occurs during the postponement period, as a termination by reason of the death of the deemed transferor, will be determined in the same manner as for property acquired from or passing from a decedent during the postponement period.

##### ***Effective date***

The amendment relating to the basis of farm property is to apply to property passing or acquired from a decedent dying after December 31, 1976, and before January 1, 1980. The generation-skipping transfer amendment applies to transfers after June 11, 1976, and before January 1, 1980.

##### ***Revenue effect***

This provision will have a negligible effect on revenues.

## **5. Fresh Start Adjustment for Certain Carryover Basis Property (sec. 702(c)(2) of the Act and sec. 1023(h) of the Code)**

### ***Prior law***

Under present law, the basis of an asset acquired from or passing from a decedent, generally, is its basis in the hands of the decedent (i.e., the basis is "carried over") increased by certain adjustments. One of the adjustments permits the basis of an asset held on December 31, 1976, to be increased to its fair market value on that date (the so-called "fresh-start" adjustment). This adjustment was intended to exclude appreciation occurring before 1977 from the carryover basis rule.

In the case of property which was a marketable bond or security, the fair market value on December 31, 1976, is its value on that date. Where, however, the property is not a marketable bond or security, the fair market value of the property on December 31, 1976, is determined under a formula which assumes that the property appreciated evenly over the holding period. Generally, the aggregate appreciation will be allocated to pre-1977 holding periods on the basis of the number of days the asset was held prior to January 1, 1977, over the total number of days the asset was held by the decedent. In order to apply the formula, the date the asset was acquired and its basis must be known. Where the decedent's basis cannot be determined after reasonable efforts by the executor, but the date (or approximate date) of acquisition is known, a special rule permits the executor and the Internal Revenue Service to assume that the decedent's basis was the fair market value of the property on the date (or approximate date) of acquisition.

### ***Reasons for change***

In some cases, it is particularly difficult for the executor to determine either the decedent's basis or the date (or approximate date) of acquisition of the property. This is especially likely to occur where the property is tangible personal property, such as an item of art, an antique, or a coin or stamp collection. In such a case, literal application of the present rules would result in loss of all benefit from the "fresh start" provision.

For these reasons, the Congress believes that a special rule should be provided so that the executor can determine the fresh start adjustment without having to ascertain the decedent's basis and the date (or approximate date) of acquisition of the property.

### ***Explanation of provision***

The Act provides a formula to determine a minimum basis which reflects the fresh start adjustment for certain property. This provision applies on a property-by-property basis for determining the basis of eligible fresh start property. (The \$60,000 "minimum basis" adjustment applicable to aggregate bases would continue to apply as under present law.)

Only property which is tangible personal property is eligible for the new provision. Thus, stocks, bonds, and other intangible assets are not eligible for this minimum basis rule.

In addition, the executor or heir must establish that the decedent held the property (or was considered to hold substituted property) on December 31, 1976, in order for the new provision to apply.

For eligible property, the adjusted basis is treated as being not less than its value on the date of the decedent's death discounted for the period of time from December 31, 1976, to the date of the decedent's death (taking into account full calendar months). Under the formula, the post-1976 appreciation is assumed to accrue at approximately 8 percent a year.

#### ***Effective date***

This provision is effective with respect to property passing or acquired from a decedent dying after December 31, 1979, which was held by the decedent on December 31, 1976.

#### ***Revenue effect***

This provision will reduce budget receipts by less than \$5 million per year beginning in fiscal 1981.

## **6. Treatment of Indebtedness Against Carryover Basis Property (sec. 702(c)(3) of the Act and sec. 1023(g) of the Code)**

### ***Prior law***

Under present law, the basis of assets acquired from or passing from a decedent, generally, is its basis "carried over" from the decedent increased by certain adjustments. Two of these adjustments permit the basis of appreciated assets to be increased by the Federal and State death taxes attributable to the appreciation (secs. 1023 (c) and (e)). Generally, these adjustments are made by apportioning the death taxes to individual items of property on the basis of the appreciation for that item as compared to the fair market value of all property included in the gross estate.

In the case of property subject to an indebtedness for which the decedent was personally liable, the full fair market value of the property is included in the gross estate and a separate deduction is taken for the indebtedness. However, in the case of property subject to an indebtedness for which the decedent was not personally liable, the value of the decedent's equity in the property (i.e., the value of the property minus the indebtedness) is included in the gross estate. In this latter case, the apportionment of the death tax basis adjustment is made by reference to the value of the decedent's equity in the property.

### ***Reasons for change***

The Congress believes that the present rule for apportioning the death tax adjustment may result in misallocating the adjustments between property subject to a nonrecourse debt and other property.

### ***Explanation of provision***

The Act provides that, for purposes of the basis adjustments, the fair market value of property is to be determined without regard to whether there is a mortgage on, or indebtedness in respect of, the property. Thus, the full value of the property unreduced by any indebtedness on the property is to be used for all purposes (i.e., the adjustment for State and Federal death taxes, the amount of the gross estate, and the amount of the appreciation) in computing the basis adjustments regardless of how the value of the property and the debt are reported for estate tax purposes.

### ***Effective date***

The provision is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year beginning in fiscal 1981.

**7. Only One Fresh Start With Respect to Carryover Basis Property Held on December 31, 1976 (sec. 702(c)(4) of the Act and sec. 1023(h) of the Code)**

***Prior law***

Under present law, the "fresh start" adjustment is permitted for property passing from a decedent where that property reflects the basis of any asset held by him on December 31, 1976. Present law does not explicitly prevent successive fresh start adjustments for property when it is successively devised, bequeathed, or transferred by interstate succession or survivorship rights by more than one decedent.

***Reasons for change***

The Congress believes that it should be made clear that the "fresh start" adjustment is to be made only once.

***Explanation of provision***

The Act amends the carryover basis provisions to provide that the fresh start adjustment will not apply where the adjusted basis of property passing from a decedent (i.e., the heir of the prior decedent) reflects the adjusted basis of property which was carryover basis property with respect to a prior decedent. However, in the case of carryover basis property which is jointly held with rights of survivorship, a fresh start adjustment is to be allowed upon the death of a surviving joint tenant for that portion of the property that was not included in the estate of the joint tenant who died first.

***Effective date***

The provision is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

***Revenue effect***

This provision has no effect upon budget receipts.

## **8. Holding Period for Carryover Basis Property (sec. 702(c)(5) of the Act and sec. 1223 of the Code)**

### ***Prior law***

Prior to the 1976 Act, all property which received a "stepped-up" basis was deemed to have been held by the estate or heirs for the period required for long-term capital gains treatment (sec. 1223(11)).

Under the 1976 Act, the basis of property acquired from or passing from a decedent, generally, is its basis in the hands of the decedent (i.e., a carryover basis). Because the basis of these assets is "carried over" to the heir or estate and is not "stepped-up" (under sec. 1014), those assets are not deemed to be held for the period required for long-term capital gain treatment.

### ***Reasons for change***

The Congress believes that the change in the basis rules made by the 1976 Act was not intended to convert what was previously long-term capital gain or loss into short-term capital gain or loss. The Congress believes that estates and heirs should continue to receive the favorable treatment accorded long-term capital gains even though the combined holding period of the decedent and the estate (or heir) is less than the holding period necessary for long-term status.

### ***Explanation of provision***

The Act provides that carryover basis property is deemed to be held by the estate or heirs for the period required for long-term capital gain treatment.

### ***Effective date***

This amendment is effective for property acquired from or passing from a decedent dying after December 31, 1979.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year beginning in fiscal 1981.

## **9. Adjustment to Carryover Basis Property for State Estate Taxes (sec. 702(c)(6) of the Act and sec. 1023(c) of the Code)**

### ***Prior law***

Under the carryover basis provisions as added by the 1976 Act, an adjustment to basis is permitted for Federal and State death taxes attributable to appreciation. With respect to State estate taxes, the adjustment is made to property subject to tax for Federal estate tax purposes. However, where the inclusion rules, or charitable and marital deduction rules, for State and Federal estate tax purposes are different, the present rule does not take these differences into account for making the basis adjustment for State estate taxes.

### ***Reasons for change***

The Congress believes that the basis of property should be entitled to be increased by any inheritance or other State death taxes that are actually imposed on that property regardless of whether that property is subject to Federal estate tax. Accordingly, the Congress believes that the adjustment to basis for State estate taxes should be made by reference to the property that is subject to tax under the applicable State laws.

### ***Explanation of provision***

The Act provides that the basis adjustment for State estate taxes on the appreciation is to be determined by reference to the inclusion and valuation rules of the applicable State law. However, the amount of appreciation in any property will continue to be determined under Federal income tax rules.

### ***Effective date***

This amendment is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year beginning in fiscal 1981.

**10. Clarification of Increase in Basis for Certain State Succession Taxes (sec. 702(c)(7) of the Act and sec. 1023(e) of the Code)**

***Prior law***

Under the carryover basis provisions as added by the 1976 Act, an adjustment to basis is permitted for State death taxes attributable to appreciation that are paid by the heir and for which the estate is not liable (sec. 1023(e)). This adjustment was intended to apply to State inheritance and succession taxes actually paid by an heir. However, under most State laws, the estate is technically liable for the payment of these taxes and, as a result, it is somewhat unclear as to whether an adjustment would be permitted in cases where the beneficiary pays the taxes.

***Reasons for change***

The Congress believes that the adjustment to basis of property for State death taxes attributable to appreciation in that property should be permitted even though the decedent's estate is technically liable for the payment of the death taxes.

***Explanation of provision***

The Act makes it clear that the adjustment for State death taxes attributable to appreciation in property will be available for State death taxes actually paid by an heir (or trust for the benefit of heirs) even though the estate of the decedent is technically liable for the payment of the tax.

***Effective date***

The amendment is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

***Revenue effect***

This provision has no effect upon budget receipts.



## **11. Coordination of Carryover Basis Adjustments (sec. 702(c)(8) of the Act and sec. 1023(h) of the Code)**

### ***Prior law***

Under the carryover basis provisions of present law, adjustments to basis are permitted for (1) the so-called "fresh-start adjustment to reflect fair market value at December 31, 1976, (2) the Federal and State estate taxes attributable to appreciation, (3) a minimum basis of \$60,000, and (4) State inheritance taxes attributable to appreciation paid by the heir. Under the order prescribed for making these adjustments, the fresh start adjustment would be made first. The fresh start adjustment would then affect the amount of the other adjustments since it would be taken into account in measuring the amount of appreciation for purposes of the death tax adjustments and in determining whether the basis of all properties was less than the \$60,000 minimum basis. However, the fresh start adjustment is taken into account only for purposes of determining gain from the sale or other disposition of the property by the estate or heirs and cannot be used to generate a loss from the sale or other disposition of the property.

### ***Reasons for change***

It has been brought to the attention of Congress that it is somewhat unclear whether recomputations of the death tax adjustments and the minimum basis adjustments for each item of property may be required every time any heir sells property.

### ***Explanation of provision***

The Act clarifies that no recomputation of basis is required for the death tax or minimum basis adjustments. Basically, the basis of "fresh start" property for loss purposes would be the same as for gain purposes except that it would not reflect the fresh start adjustment.

### ***Effective date***

This amendment is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

### ***Revenue effect***

This provision has no effect upon budget receipts.

## **12. Basis for Certain Term Interests (sec. 702(c)(9) of the Act and sec. 1001(e) of the Code)**

### ***Prior law***

In determining the amount of gain or loss from the sale of a term interest (such as a life estate, term of years, or an income interest in a trust), the basis of property acquired or passing from a decedent or transferred by gift is not generally taken into account by the holder of the term interest. A conforming amendment was not made under the 1976 Act to apply this provision to carryover basis property.

### ***Reasons for change***

The Congress believes that the basis for determining gain or loss for sales or exchanges of term interests in carryover basis property should be subject to the general rules applicable to sales or exchanges of term interests.

### ***Explanation of provision***

The Act applies the basis rule for sales or other dispositions of term interests to carryover basis property.

### ***Effective date***

This amendment is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

### ***Revenue effect***

This provision has no effect upon budget receipts.

### **13. Clarification of the Rules Relating to Special Use Valuation (sec. 702(d)(1) of the Act and sec. 2032A of the Code)**

#### ***Prior law***

Under the 1976 Act, if certain conditions are met, "qualified real property" may be valued for estate tax purposes at its farm or business use value, rather than at its value based on "highest and best" use. To qualify for the special use valuation rule, several requirements must be satisfied. First, the real property must have been owned by the decedent (or a member of his family) and used for farm or business purposes for five of the eight years preceding the decedent's death. Second, a substantial portion of the adjusted gross estate must consist of qualified property, i.e., 50 percent must consist of real and personal property used in the business and 25 percent must consist of real property used in the business. Third, the qualified property (the portion satisfying the 50- and 25- percent tests) must pass to members of the decedent's family (known as "qualified heirs"). Also, the decedent or a member of his family must have materially participated in the business in which the property is used for five of the eight years preceding the decedent's death.

#### ***Reasons for change***

Under present law, it is not clear whether, if the estate otherwise qualifies and appropriate amounts of qualifying property pass to qualified heirs, other property which is used in a qualifying use can be valued under the special use valuation rules if it passes to nonfamily members—i.e., persons who are not qualified heirs.

The intent of Congress was to provide special use valuation only for property which remained in the hands of the decedent's family and which was being used for a qualified use both before and after the decedent's death.

#### ***Explanation of provision***

The Act explicitly provides that real property is eligible for special use valuation only to the extent that it passes to qualified heirs.

#### ***Effective date***

This provision applies to the estates of decedents dying after December 31, 1976.

#### ***Revenue effect***

This provision will have no effect on budget receipts.

#### **14. Use of Special Use Valuation Property to Satisfy Pecuniary Bequest (sec. 702(d)(2) of the Act and sec. 2032A of the Code)**

##### ***Prior law***

Under the Tax Reform Act of 1976, qualified real property which passes from a decedent to a qualified heir is generally eligible for special valuation rules. Under present law, the distribution of property by an estate or trust in satisfaction of a pecuniary bequest is treated as a taxable transaction resulting in the recognition of gain or loss to the estate. Under the tax law, for most purposes, if property is distributed in a taxable transaction, the property is not considered to have been acquired from or passed from a decedent.

##### ***Reason for change***

Due to the interaction of the rules described above, there is a technical question as to whether property otherwise qualifying for the special estate tax valuation rule will qualify if it is distributed pursuant to a pecuniary bequest.

##### ***Explanation of provision***

The Act provides that, under the special use valuation provision, property shall be considered to have been acquired from, or to have passed from, a decedent if it is acquired by any person from the estate in satisfaction of the right of the person to a pecuniary bequest (as well as if it were acquired from the decedent by a specific bequest or the equivalent of a pecuniary bequest). Thus, property will not become ineligible for the special valuation rule solely because it is distributed to a qualified heir in satisfaction of a pecuniary bequest.

##### ***Effective date***

This provision applies to estates of decedents dying after December 31, 1976.

##### ***Revenue effect***

This provision will have no effect on budget receipts.

**15. Gain Recognized on Use of Special Use Valuation Property to Satisfy Pecuniary Bequest (sec. 702(d)(3) of the Act and sec. 1040 of the Code)**

***Prior law***

Under present law, the distribution of property by an estate or trust in satisfaction of a pecuniary bequest is treated as a taxable transaction resulting in the recognition of gain or loss to the estate.

Under the law prior to the 1976 Act, the amount of gain recognized on a distribution in satisfaction of a pecuniary bequest was limited to post-estate tax valuation date appreciation because the estate received a stepped-up basis for the property. As a conforming change under the carryover basis provisions added by the 1976 Act, the Act also provided that, where an estate distributes property in satisfaction of a pecuniary bequest, gain is recognized by the estate only to the extent of the appreciation occurring from the estate tax valuation to the date of distribution.

The limitation on gain recognized by the estate was intended to provide substantially the same income tax treatment provided under prior law for a pecuniary bequest distribution. However, under the 1976 Act, the amount of post-death appreciation is considered to be the difference between the value of the property for estate tax purposes and its fair market value on the date of distribution. Thus, if the statute is literally applied where property is subject to special farm or other business use valuation, a portion of the pre-death appreciation will be included in the gain recognized by the estate because the gain would be the excess of the value at the time of distribution over the special use value used for estate tax purposes.

***Reasons for change***

Where property qualifies for special farm or other business use valuation, it was not the intent of Congress to subject the benefit from the special use valuation to income tax upon distribution of the property to satisfy a pecuniary bequest.

***Explanation of provision***

The 1978 Act provides that the special use valuation provision is not to be taken into account in determining the post-death appreciation subject to income tax when an estate or trust satisfies a pecuniary bequest with appreciated property. Thus, the appreciation subject to tax will be measured by the difference between the fair market value of the property on the date of distribution (without regard to special use valuation) and the fair market value of the property on the date of the decedent's death or the alternate valuation date (determined without regard to the special use valuation provision).

***Effective date***

This provision applies to estates of decedents dying after December 31, 1979.<sup>1</sup>

***Revenue effect***

This provision will have a negligible effect upon budget receipts.

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<sup>1</sup> The effective date of this provision is deferred until 1980 as a result of the 3-year deferral to the carryover basis provisions made by section 515 of the 1978 Act. In addition, section 702(c)(1) of the 1978 Act provides that the basis of farm property for which special valuation is elected and which is acquired from a decedent dying during 1977, 1978 or 1979 is the amount determined under the special valuation provision. The interaction of these two provisions will cause gain other than that attributable to post-death appreciation to be realized on the satisfaction of a pecuniary bequest of farm recapture property acquired from a decedent dying before 1980. It is anticipated the corrective legislation will be enacted in order to change this result.

**16. Treatment of Community Property Under Special Use Valuation Provision (sec. 702(d)(4) of the Act and sec. 2032A of the Code)**

***Prior law***

Under prior law, it was unclear whether the special use valuation provision for qualified real property applied in the same manner to property held as community property as it did to property held by the decedent as his individual property in a common law State.

***Reasons for change***

The Congress wishes to clarify the present law so that the special use valuation provision is to apply to community property in the same manner as property that is not community property.

***Explanation of provision***

The Act makes it clear that the special use valuation provision is to apply to community property in the same manner as property owned by the decedent in his individual capacity. For example, the entire value of the property will be taken into account for purposes of determining if the percentage qualification requirements are satisfied.

***Effective date***

This provision is effective with respect to estates of decedents dying after December 31, 1976.

***Revenue effect***

This provision will have no effect on budget receipts.

**17. Substitution of Bond for Personal Liability of Qualified Heir for Recapture of Tax with Respect to Special Use Valuation Property (sec. 702(d)(5) and sec. 2032A of the Code)**

***Prior law***

Under present law, if an executor of an estate elects to value certain qualifying real property under the special use valuation provision, there are certain circumstances which would result in the recapture of the estate tax savings. All or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are to be recaptured if, within 15 years after the death of the decedent (but before the death of the qualified heir), the qualifying property is disposed of to nonfamily members, the qualifying property ceases to be used for farming or other closely held business purposes, or the family members cease to materially participate in the farm or other closely held business.

Under this provision, the qualified heir is personally liable for the recapture tax imposed with respect to his interest in qualified real property, and there is a lien on the qualified real property. There was no provision under prior law which would relieve the qualified heir of his personal liability, even though he is willing to provide a bond to secure the amount of his personal liability.

***Reasons for change***

The Congress believes it is appropriate to allow a qualified heir to be relieved of potential personal liability if an appropriate bond is furnished.

***Explanation of provision***

The Act provides that a qualified heir may be discharged from personal liability and shall be entitled to a receipt or writing showing this discharge if he furnishes a bond which meets certain requirements. In order to comply with this bond procedure, the qualified heir must make written application to the Secretary of the Treasury for a determination of the maximum amount of the additional tax which may be imposed by the special farm valuation provision with respect to his interest. The Secretary is required to notify the heir of the maximum amount of the recapture tax as soon as possible and, in any event, within one year after the making of the application. If the qualified heir furnishes a bond in this amount and for such period as may be required (which, in general, should be no longer than the period to which the recapture tax applies), he shall be discharged from personal liability.

The maximum amount of the bond does not include interest on the amount of the qualified heir's personal liability, even though interest may accrue on the amount of the recapture tax imposed from the date of imposition until the date the tax is paid.



***Effective date***

These provisions will apply with respect to the estates of decedents dying after December 31, 1976.

***Revenue effect***

This provision will have no effect on budget receipts.

## **18. Security Where Extended Payment Provisions are Elected (sec. 702(e) of the Act and sec. 6324A of the Code)**

### ***Prior law***

Under present law as amended by the 1976 Act, there are two provisions permitting extended payment of estate taxes (over 15- or 10-year periods) where a farm or closely held business constitutes a substantial portion of the decedent's estate. Prior to the 1976 Act, where extended payment was elected, the executor was generally personally liable for the deferred estate taxes unless he posted bond equal to double the amount of the unpaid tax.

The 1976 Act permitted the executor to be relieved from personal liability for the unpaid tax where either of these extended payment provisions is elected. Instead, if elected, a lien attaches to real property and other assets with long useful lives until the deferred taxes are paid. The amount of the lien is equal to the deferred tax liability plus the total amount of interest which will be payable on the deferred taxes.

### ***Reasons for change***

The Congress does not believe it is necessary to require security for the amount of the deferred taxes plus the full amount of the interest payable over the deferral period. If a payment of tax is missed or another event occurs which accelerates the payment of the tax, collection would ordinarily be completed within a relatively short time after the accelerating event. Consequently, it appears that adequate security to protect the Government's interest would be provided if the maximum amount of security included the amount of the deferred tax liability plus an amount equal to the interest payable for the first four years of the payment period.

### ***Explanation of provision***

The Act provides that the maximum amount of property which is to be required to be subject to a lien if the executor elects to be discharged from personal liability (under sec. 6324A) shall not be greater than the sum of the deferred amount of the unpaid estate tax liability plus the aggregate amount of interest which would be payable over the first four years of the period over which the tax liability is deferred. It is anticipated that the IRS will permit a reduction in the maximum amount as deferred taxes and interest are paid. Also, in cases where sufficient property is not available or offered to be subject to the lien, the difference between this maximum amount and the amount of property tendered can be satisfied by the furnishing a bond.

### ***Effective date***

This provision applies to the estates of decedents dying after December 31, 1976.

### ***Revenue effect***

This provision will have no effect on budget receipts.

## **19. Transfers Within Three Years of Death (sec. 702(f) of the Act and sec. 2035 of the Code)**

### ***Prior law***

Under the 1976 Act, transfers made by a decedent within three years of death are included in the decedent's gross estate without regard to whether the gifts were actually made in contemplation of death. However, the 1976 Act provided an exemption to the automatic three-year inclusion rule for gifts excludable under the \$3,000 annual gift tax exclusion. Under this exception, the legislative history indicated that the amount of gifts included in the gross estate is limited to the excess of the estate tax value over the amount excludable with respect to these gifts.

### ***Reasons for change***

The Congress is concerned that this rule will impose serious administrative burdens upon executors as it will be necessary to ascertain whether the decedent had made gifts during the 3-year period (even though no return was required), and, if there were any gifts, the value of the gifts at the time of the donor's death.

### ***Explanation of provision***

The Act provides that the exception to the transfer within 3 years of death estate tax inclusion rule applies to gifts made to a donee where no gift tax return was required to be filed with respect to the gifts, e.g., gifts of present interests to a donee that do not exceed \$3,000 in a calendar year. If the gifts are required to be shown on a gift tax return, the gifts made within three years of the decedent's death are required to be included in the decedent's gross estate. For example, a gift of a present interest in property valued at \$3,500 which is made within 3 years of death would be includible in the donor's gross estate even though the gift was fully excludable because the other spouse consented to be treated as the donor of one-half of the gift.

This exception does not apply to any transfer with respect to a life insurance policy. However, the exception does apply to any premiums paid (or deemed paid) by the decedent within 3 years of death to the extent that such payments, together with other gifts to the donee, are excludable under the annual exclusion. On the other hand, the exception does not apply to any transfer which would have resulted in inclusion in the gross estate of the proceeds of the policy under the law prior to the 1976 Act because the transfer was considered made within 3 years of death (by reason of policy renewal rights, premium payments, or any other factor, other than the existence of a contemplation of death motive, to the extent these factors were relevant to includibility of the proceeds in the gross estate of a decedent under prior law).

***Effective date***

This provision applies to estates of decedents dying after December 31, 1976, except that it does not apply to transfers made before January 1, 1977.

***Revenue effect***

This provision will have no effect on budget receipts.

**20. Coordination of Gift Tax Exclusion and Marital Deduction and Estate Tax Marital Deduction (secs. 702(g) (1) and (2) of the Act and secs. 2035 and 2056 of the Code)**

***Prior law***

Under present law, as amended by the 1976 Act, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first \$100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal lifetime transfers in excess of \$200,000. (The 1976 Act did not change the ordering rule of section 2524, i.e., the annual exclusion is taken into account first before a portion of the gift to a spouse is considered to be deductible under the marital deduction provision.)

In addition, where interspousal lifetime transfers are less than \$200,000, the allowable estate tax marital deduction is reduced (or "cut-down") by the excess of the gift tax marital deduction with respect to gifts made after 1976 over 50 percent of the value of such gifts. Under this rule, where the unlimited \$100,000 gift tax marital deduction has been used up but the aggregate gifts of a spouse do not exceed \$200,000, the present formula will reduce the estate tax marital deduction "cut-down" where subsequent gifts of \$3,000 or less are made to a spouse during a year (which are excluded from tax and for which a gift tax return is not required) because the "cut-down" is reduced by one-half the value of such subsequent gifts. In addition, no exception to the restoration of the "cut-down" in the allowable estate tax marital deduction is made where an interspousal lifetime gift is brought back into the estate of the donor spouse by reason of section 2035 (relating to transfers within 3 years of death).

***Reasons for change***

Because no gift tax return is required to be filed where the total gifts to a donee (other than gifts of a future interest) do not exceed \$3,000 per year, the Congress believes that relieve executors should be relieved of the administrative difficulties in determining the amount of these small gifts for purposes of computing the allowable marital estate tax deduction. Further, where property which was given to the decedent's spouse is included in the decedent's estate by reason of section 2035, Congress believes that the estate tax marital deduction should not be reduced because inclusion in the gross estate will negate any benefit derived from the gift tax marital deduction.

***Explanation of provision***

The Act amends the estate tax marital tax deduction in two respects. First, it excludes any gift not required to be included in a gift tax return from the computation of the estate tax marital deduction "cut-down" (under sec. 2056(c)(1)(B)). Second, it provides that the

estate tax marital deduction will not be reduced on account of any gifts to the surviving spouse which were included in the decedent's estate solely by reason of section 2035.

***Effective date***

This provision applies with respect to estates of decedents dying after December 31, 1976.

***Revenue effect***

This provision will have no effect on budget receipts.

## **21. Split Gifts Made Within Three Years of Death (sec. 702(h) of the Act and sec. 2001 of the Code)**

### ***Prior law***

Under the gift tax law, a spouse may consent to be treated as the donor of one-half of a gift made by the other spouse to a third party. This is referred to as "gift splitting." Under the 1976 Act, where the donor spouse dies within 3 years of making a "split gift," the entire gift is included in the donor spouse's estate and any gift tax actually paid by the consenting spouse on the gift is allowed as a credit in determining the estate tax for the estate of the donor spouse. However, the transfer tax consequences to the consenting spouse are not reversed. For example, any unified credit used is not restored and the amount of aggregate taxable gifts for prior periods is not adjusted.

### ***Reasons for change***

Congress believes that, where a spouse consents to be treated as the donor of one-half of a gift to a third party but the full amount of the gift is included in the other spouse's estate, the estate tax for the consenting spouse should be determined without regard to that gift since the benefits of gift splitting have been generally eliminated by inclusion of the gift in the other spouse's gross estate.

### ***Explanation of provision***

The Act provides for the reversal of the transfer tax consequences of gift splitting to the estate of the consenting spouse if the gift is included in the gross estate of the donor spouse as a transfer made within three years of death. In computing the estate tax for the consenting spouse, the Act excludes the gift in determining the amount of lifetime transfers under the unified transfer system. However, the gift tax paid by the consenting spouse would not be taken into account as a credit against the estate tax of the consenting spouse if it had been allowed as a credit to the estate of the donor spouse.

### ***Effective date***

This provision applies with respect to the estates of decedents dying after December 31, 1976, except that it does not apply to transfers made before January 1, 1977.

### ***Revenue effect***

This provision will have no effect on budget receipts.

## **22. Inclusion in Gross Estate of Stock Transferred by the Decedent Where the Decedent Retained Voting Rights (sec. 702(i) of the Act and sec. 2036(b) of the Code)**

### ***Prior law***

Under present law, the retention of certain powers or interests by a decedent in property transferred by the decedent during his lifetime results in the property being includible in his gross estate for estate tax purposes (sec. 2036). The 1976 Act extended this rule to the retention of voting rights in stock of any corporation which was transferred by the decedent during his lifetime even if the corporation was not a controlled corporation. This rule is often called the “anti-*Byrum*” rule because it was intended to overrule the result reached in that case by the U.S. Supreme Court.

### ***Reasons for change***

The rule in the 1976 Act required the inclusion of any stock over which the decedent retained a power to vote regardless of whether the corporation was controlled by the decedent. The Congress believes that the retention of voting power should result in the inclusion of the stock in the decedent's gross estate only where the decedent and his relatives own 20 percent or more of the voting stock of the corporation.

In addition, the Congress believes that the rule should be clarified with respect to the retention of voting rights in certain indirect transfers as well as direct transfers of stock in a controlled corporation.

### ***Explanation for provision***

The Act makes two amendments to the rule contained in the 1976 Act. First, the Act restricts the rule to stock in corporations which are controlled by the decedent and his relatives. Second, the Act clarifies the rule under the 1976 Act that indirect transfers are subject to the rule.

Under the Act, the rule requiring inclusion in the gross estate only applies to stock in a “controlled corporation.” Where the stock is not in a “controlled corporation”, the stock is not included in the gross estate of the decedent even if the decedent directly held the power to vote those shares.

A “controlled corporation” is defined to mean a corporation where the decedent together with his spouse, children, grandchildren and parents owned, or had the right to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock. The constructive ownership rules of section 318 apply solely for purposes of determining whether the corporation is a controlled corporation. In addition, in order for the corporation to be controlled, the ownership of, or right to vote, 20 percent of the total combined voting power of all classes of stock had to occur any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death.

The rule requiring inclusion in the gross estate of stock of a controlled corporation applies where the decedent retained the voting



rights of the stock which was directly or indirectly transferred by him. Thus, where the decedent transferred cash or other property prior to his death to a trust of which he is trustee within 3 years of his death, and then the trust uses that cash or other property to purchase stock in a controlled corporation from himself, the value of the stock would be included in his gross estate. In addition, the indirect retention of voting rights in the case of reciprocal transfers of stock in trust would result in the inclusion of the stock with respect to which the decedent had voting rights as trustee. However, voting rights in stock transferred in trust by the decedent will not be considered to have been retained by the decedent merely because a relative was the trustee who voted the stock. In these cases, the voting rights would be considered to have been indirectly retained by the decedent if in substance the decedent had retained such voting rights, e.g., there had been an arrangement or agreement for the trustee to vote the stock in accordance with directions from the decedent.

The rule would not apply to the transfer of stock in a controlled corporation where the decedent could not vote the transferred stock. For example, where a decedent transfers stock in a controlled corporation to his son and does not have the power to vote the stock any time during the 3-year period before his death, the rule does not apply even where the decedent owned, or could vote, a majority of the stock. Similarly where the decedent owned both voting and nonvoting stock and transferred the nonvoting stock to another person, the rule does not apply to the nonvoting stock simply because of the decedent's ownership of the voting stock.

#### ***Effective date***

This provision is effective with respect to decedents dying after December 31, 1976.

#### ***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

**23. Estate Tax Exclusion for Certain Retirement Benefits (sec. 702(j)(1) of the Act and sec. 2039(d) of the Code)**

***Prior law***

Under present law as amended by the 1976 Act, in general, the value of an annuity receivable by a beneficiary (other than the executor) under an individual retirement account is excluded from a decedent's gross estate. The exclusion applies only to the portion of the account attributable to contributions which were allowable as a deduction for income tax purposes or attributable to rollover contributions from a tax-qualified plan.<sup>1</sup>

This exclusion specifically refers to individual retirement accounts, individual retirement annuities, and retirement bonds for which a deduction was allowable under section 219 of the Code, but does not refer to the new spouse-covered plans for which a deduction is allowable under section 220.

***Reasons for change***

The Congress believes an individual retirement account for an individual and his spouse should be treated in the same way as other individual retirement accounts for purposes of the estate tax exclusion.

***Explanation of provision***

The Act makes it clear that annuities receivable by a beneficiary (other than the executor) under a spouse-covered individual retirement account (sec. 220) may qualify for the estate tax exclusion.

***Effective date***

This provision applies to estates of decedents dying after December 31, 1976.

***Revenue effect***

This provision will have no effect on budget receipts.

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<sup>1</sup> However, the estate tax exclusion is limited to an annuity receivable under a qualifying program.

**24. Annual Exclusion for Spouse's Interest in an Individual Retirement Account (sec. 702(j)(2) of the Act and sec. 2503 of the Code)**

***Prior law***

Under present law as modified by the 1976 Act, an eligible individual can contribute up to \$875 to his own IRA and \$875 to an IRA separately owned by a spouse, or can contribute up to \$1,750 to an IRA which credits \$875 to a subaccount for the husband and \$875 to a subaccount for his wife ("SIRA").

A taxpayer who makes a gift to another person is generally subject to a gift tax on the amount of such gift. However, present law provides an annual exclusion of \$3,000 per donee for a donor to the extent that the donee receives a present interest in the property.

Under the SIRA rules, the spouse of the individual establishing the account or annuity must be given a vested interest in the account or annuity. However, since the spouse cannot receive benefits from the SIRA until age 59½, without a significant tax penalty, the contribution made on behalf of the spouse would probably be treated as a transfer of a future interest and not eligible for the \$3,000 annual per donee exclusion.

***Reasons for change***

The Congress believes that the spouse's interest in an individual retirement account should be considered a present interest eligible for the gift tax annual exclusion.

***Explanation of provision***

The Act provides that the contribution by an individual to a SIRA for his spouse (whether in the form of an individual retirement account, individual retirement annuity, or retirement bond) constitutes a gift of a present interest in property (within the meaning of section 2503) rather than a gift of a future interest. Consequently, the amount of the contribution for the benefit of a spouse is eligible to be treated as a portion of the \$3,000 annual exclusion of gifts to the spouse.

***Effective date***

The provision applies to transfers made after December 31, 1976.

***Revenue effect***

This provision will have no effect on budget receipts.

## **25. Gift Tax Consequences From the Creation of a Joint Tenancy in Personal Property (sec. 702(k)(1) of the Act and sec. 2515A of the Code)**

### ***Prior law***

Under present law, the creation of a joint tenancy in personal property with rights of survivorship constitutes a gift to the extent that the contribution made by a tenant exceeds the tenant's retained interests in the property. A similar rule applies in the case of a joint tenancy created in real property without rights of survivorship between spouses. In the case of a joint tenancy in real estate with rights of survivorship between spouses, no gift tax is imposed unless the donor spouse elects to treat the creation of the joint tenancy as a gift. Prior to the 1976 Act, when an election was made, the amount of the donor spouse's retained interest in realty was determined by use of actuarial factors if, under applicable local law, neither joint tenant could unilaterally sever the joint tenancy.

The 1976 Act eliminated the need to use actuarial calculations in the case of the creation of a joint tenancy by the husband and wife in real property. Under the Act, the retained interest of each spouse is considered to be one-half the value of the property even if neither joint tenant can unilaterally sever the joint tenancy. However, the rule eliminating the use of actuarial values did not apply to the creation of a joint tenancy between husband and wife in personal property.

### ***Reasons for change***

The Congress believes that the rules adopted in the 1976 Act to simplify the determination of the amount of the gift in the case of joint tenancies in real property should also apply with respect to the creation of a joint tenancy in personal property.

### ***Explanation of provision***

The Act generally eliminates actuarial calculations in determining the amount of a gift with respect to the creation of a joint tenancy between husband and wife in personal property. However, actuarial calculations will continue to be required if the fair market value of the joint interest of the personal property cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses. Thus, for example, the amount of a gift would continue to be determined actuarially in the case of a gift involving a joint and survivor annuity.

### ***Effective date***

The provision applies to joint interests created after December 31, 1976.

### ***Revenue effect***

This provision will reduce the budget receipts by less than \$1 million per year.

**26. Fractional Interest Rule for Certain Joint Tenancies (sec. 702(k)(2) of the Act and sec. 2040 of the Code)**

***Prior law***

Prior to the 1976 Act, the estate tax law provided that, on the death of a joint tenant, the entire value of the property owned in joint tenancy was included in a decedent's gross estate except for the portion of the property which is attributable to the consideration furnished by the survivor.

The 1976 Act added a provision which provided that, in the case of a "qualified joint interest" created after December 31, 1976, one-half of the value of a joint interest would be included in an estate of the first tenant to die. A qualified joint interest is a joint tenancy between a decedent and his spouse created by one or both spouses, the creation of which, in the case of personal property, constituted a gift in whole or in part or, in the case of real property, as to which an election was made to treat the creation as a transfer of property. Although the 1976 Act made no change with respect to joint interests created before January 1, 1977, a taxpayer can receive the benefit of the new fractional interest rule by severing an existing joint tenancy and re-creating it if the re-creation is subject to a gift tax.

***Reasons for change***

The Congress believes that a donor spouse should be allowed to have a pre-1977 joint tenancy treated as a "qualified joint interest" without going through a formal severance and re-creation of the joint tenancy.

***Explanation of provision***

The Act allows a donor spouse to have a pre-1977 joint tenancy to be treated as a "qualified joint interest" without formally severing the joint tenancy and then re-creating it. This treatment is to be available if the taxpayer elects to report a gift of the property in a gift tax return filed with respect to any calendar quarter in 1977, 1978 or 1979. A taxpayer making the election is to be treated as having made a gift at the close of calendar quarter for which the return is timely filed. The amount of the gift generally is to be equal to the appreciation attributable to the gift portion of the consideration furnished by the donor spouse at the time of the creation of the joint interest.

***Effective date***

This provision applies to a joint tenancy created before January 1, 1977, if the donor makes an election under this provision on a timely-filed gift tax return for any calendar quarter in 1977, 1978, or 1979.

***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.

## **27. Orphans' Exclusion Where There is a Trust for Minor Children (sec. 702(1) of the Act and sec. 2057 of the Code)**

### ***Prior law***

The 1976 Act provided a new deduction for estate tax purposes for amounts passing from the decedent to his orphaned children. The deduction with respect to each child is limited to \$5,000 multiplied by the number of years that the child is under 21 years of age at the death of the decedent.

In order to qualify for the deduction, the property passing to the orphaned child may not be a terminable interest (such as a life estate), except that the property is permitted to pass to a person other than the child's estate if the child dies before the youngest living child attains age 21. Because of the terminable interest rule, it is not presently possible to create a single trust for the benefit of a number of orphaned children as a group unless separate shares are created in the trust for each child.

### ***Reasons for change***

The Congress believes that it should be possible to create a single trust for all of the decedent's orphaned children because the costs of administering separate trusts (or even separate shares of a single trust) may be prohibitive. Moreover, the Congress believes sufficient flexibility should be provided to permit the trustee to accumulate income and make disproportionate distributions to orphaned children depending upon their relative needs so long as the distributions are made under certain ascertainable standards and each child will receive a pro rata portion of the trust upon termination of the trust. In addition, the Congress believes that termination of the trust should not be required until the youngest child attains age 23.

### ***Explanation of provision***

The Act amends the provision relating to the orphan's deduction under which property passing to a trust which meets certain requirements, called a "qualified minors' trust," qualifies for the orphan's deduction. These requirements relate to (1) the source of the trust corpus, (2) eligible beneficiaries of the trust, (3) restrictions on distributions to beneficiaries, (4) the conditions under which distributions to beneficiaries other than the orphans may be made by the trust prior to its termination, and (5) disposition of the trust property at its termination.

Under the Act, all of the initial corpus of a qualified minors' trust must be property which passes or has passed from the decedent to the trust. Thus, initial funding of the trust by the decedent's spouse or from third parties is not permitted. However, the initial corpus of the trust includes any income accumulated by the estate or trust during the administration of the estate.

All of the beneficiaries who initially have a present interest in the trust must be the decedent's children who have not attained age 21 at the date of the decedent's death. If a child of the decedent is 21 years of age or older on the date of the decedent's death, he cannot initially be a beneficiary with a present interest in the trust. (Such a person, however, may have a future interest in the trust.)

All distributions to children of the decedent must be made either pro rata to all beneficiaries of the trust or must be made under one or more specified ascertainable standards. A distribution will satisfy the pro rata standard if made on a per-capita basis to those who are the remaining eligible beneficiaries of the trust at the time the distribution is made. The specified ascertainable standards permitted under the Act are standards relating to the health, education, support, or maintenance of the beneficiaries.<sup>1</sup> Under the Act, the ascertainable standard used by the trust may be any, or any combination, of the four specified standards.

Moreover, under the Act, the trustee may be given absolute or sole discretion to accumulate or distribute the income of the trust (subject to the rules above). Thus, under the Act, it would be permissible to grant the trustee the power to accumulate income or to distribute corpus or income (current and accumulated) to the decedent's children for their health, education, support, or maintenance.

Distribution prior to the termination of the trust to persons other than the decedent's children may be made only at the death of the children and, in such event, that child's pro rata portion of the trust corpus and accumulated income at that time (determined on a per-capita basis) must be either (1) distributed to any person, (2) vested in a separate share in the trust for any person, or (3) remain in the trust for the benefit of the other surviving minors. For example, upon the death of a child, it would be permissible to provide that the child's pro rata portion of the trust would be distributed to the child's heirs. Likewise, it would be permissible to provide that, in the event of a child's death, his share shall remain in trust as a separate share for the benefit of his heirs. The interest of a child is not to be disqualified because it may pass to another person if the child dies before the youngest child attains age 23. Where the trust instrument does not provide for the distribution or vesting of a child's portion in a separate share of the trust upon his death, that child's portion must remain in the trust for the benefit of the remaining children of the decedent.

Upon termination of the trust, all of the then corpus and any accumulated income of the trust (other than property in separate shares) must be distributed on a pro rata basis to the beneficiaries living as of the terminating event. Prior distributions, even if disproportionately made under an ascertainable standard, are not taken into account in determining each beneficiary's pro rata share of a terminating distribution. Thus, the pro rata standard would be satisfied if the terminating distribution of trust corpus and accumulated income, immediately before the distribution, is made on a per-capita basis to those who are the remaining eligible beneficiaries. The trust need not terminate or vest until the youngest child of the decedent attains age 23.

<sup>1</sup> These are the same standards presently contained in sec. 2041 of the Code which are used in defining what is not a general power of appointment.

***Effective date***

This provision is effective with respect to decedents dying after December 31, 1976.

***Revenue effect***

This provision will reduce budget receipts by less than \$1 million per year.



## **28. Disclaimers (sec. 702(m) of the Act and sec. 2518 of the Code)**

### ***Prior law***

Under the 1976 Act, in order for a disclaimer to be valid for purposes of estate, gift and generation-skipping transfer taxes so that the person disclaiming is not treated as having transferred the property, the disclaimed interest must pass to a person other than the person making the disclaimer. To satisfy this requirement, the person making the disclaimer cannot have the authority to direct the transfer of the property to another person. It is presently unclear as to whether a disclaimer is valid for transfer tax purposes where a surviving spouse refuses to accept all or a portion of an interest in property passing from the decedent and, as a result of that refusal, the property passes to a trust in which the spouse has an income interest or other interest.

### ***Reasons for change***

Th Congress believes that, where the decedent's spouse refuses to accept all or a portion of his or her interest in property passing from the decedent and, as a result of that refusal, the property passes to a trust in which the spouse has an income or other interest, such disclaimer should be recognized as a qualified disclaimer.

### ***Explanation of provision***

The Act provides that where a surviving spouse refuses an interest in property, the disclaimer will be valid although the surviving spouse receives an interest with respect to the property if the interest does not result from any direction by the surviving spouse and the disclaimer is otherwise qualified.

### ***Effective date***

This provision applies to transfers creating an interest in the person disclaiming made after December 31, 1976.

### ***Revenue effect***

This provision has no effect upon budget receipts.

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## **29. Effective Date of Generation-Skipping Provisions (sec. 702(n) of the Act and sec. 2006(c) of the Tax Reform Act of 1976)**

### ***Prior law***

Under present law, as adopted under the Tax Reform Act of 1976, the generation-skipping provisions apply generally to transfers made after April 30, 1976. However, exceptions apply in the case of generation-skipping transfers made pursuant to irrevocable trusts in existence on that date. An exception is also made in the case of decedents dying before January 1, 1982, if a generation-skipping transfer is made pursuant to a will (or revocable trust) which was in existence on April 30, 1976, and which was not amended at any time after that date (except in respects which do not result in the creation of, or increase in the amount of, a generation-skipping transfer).

### ***Reasons for change***

The April 30, 1976, effective date was adopted by Congress to preclude tax benefits arising from transfers made in anticipation of changes being considered by the Congress (which were ultimately adopted as part of the Tax Reform Act of 1976). However, it has come to the attention of the Congress that certain taxpayers made changes in their estate plans after April 30, 1976, but on or before June 11, 1976 (the date of the Senate Finance Committee's decision to adopt new rules in the generation-skipping area), not for purposes of last minute tax planning, but because they may have been unaware of the Congressional consideration which was then taking place.

The Congress believes that this result is inequitable. On the other hand, the Congress also believes that after June 11, 1976, the date of the Senate Finance Committee's decision in this area, Congressional consideration of the area of generation-skipping trusts had received sufficient publicity so that individuals were (or should have been) aware after that date that Congressional action was probable.

### ***Explanation of provision***

The Act provides that the generation-skipping transfer provisions are to apply to transfers made after June 11, 1976, rather than after April 30, 1976, as originally adopted. Therefore, the new rules apply generally to generation-skipping transfers made after June 11, 1976. Irrevocable trusts in existence on June 11, 1976, are protected under a grandfather clause except for additions to corpus after that date. Also wills and revocable trusts in existence on June 11, 1976, which were not amended after that date (except in respects which do not affect generation skipping), are protected in the case of decedents dying before January 1, 1982. Also, the 1982 cutoff date may be extended under certain circumstances where the testator was incompetent to change the disposition of his property on June 11, 1976.

In all other respects, the Congress intends that the effective date and transitional rule provisions adopted under the Tax Reform Act of 1976 are not to be affected by this amendment.

***Effective date***

The amendment is to take effect as of the date of enactment of the Tax Reform Act of 1976. Thus, transfers made after April 30, 1976, and before June 12, 1976, are exempt from the generation-skipping tax under the amendment.

***Revenue effect***

The revenue effect of this provision cannot be estimated for lack of information on the particular trusts involved.

**30. Certain Powers of Independent Trustees Not Treated as a Power for Purposes of the Tax on Generation-Skipping Transfers (sec. 702(n)(2) of the Act and sec. 2613(e) of the Code)**

***Prior law***

Under present law as modified by the 1976 Act, a tax is imposed in the case of generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir (for example, a great grandchild of the grantor) or upon the termination of an intervening interest in the trust (for example, the termination of an interest held by the grantor's grandchild). In general, a generation-skipping trust is one which provides for a splitting of benefits between two or more generations which are younger than the generation of the grantor of the trust.

For a trust to be a generation-skipping trust, the trust must have "beneficiaries" who belong to two or more generations which are younger than the generation of the grantor of the trust. Under present law, a beneficiary means anyone who has a present or future interest or power in the trust.

The term "power" means any power to alter or establish the beneficial enjoyment of the corpus or income of the trust. However, there is an exception to this rule which provides that, if an individual only has a power to dispose of the corpus or the income of the trust to a beneficiary or class of beneficiaries who are lineal descendants of the grantor and who are assigned to a generation younger than the generation of the individual holding the power, this individual shall be treated as not having a power in the trust.

***Reasons for change***

Under present law, unless the exception described above applies, an individual trustee who has a power to spray or sprinkle income or corpus would also be a beneficiary of a trust even if he has no beneficial interest in the trust. Thus, for example, an individual trustee who has only a power to allocate income or corpus among beneficiaries of the trust could himself be a beneficiary for purposes of the generation-skipping rules if the other beneficiaries with a present interest include an individual who is not a lineal descendant of the grantor. If the individual trustee is a younger generation beneficiary of the trust (either because he is a lineal descendant of the grantor or because he is more than 12½ years younger than the grantor), the death or resignation of the trustee may give rise to a generation-skipping transfer.

This result is inappropriate in the case of an individual trustee who is independent of the grantor and the beneficiaries of the trust. This is true, at least in part, because it discriminates against such individual trustees as opposed to corporate trustees.

### ***Explanation of provision***

The Act adds a new exception to the rules described above by providing that an individual trustee shall not be treated as having a power in a trust if (1) he has no interest in the trust other than as a potential appointee under a power of appointment held by another; (2) he does not have any present or future power in the trust other than a power to allocate the corpus of the trust, or to distribute or accumulate the income to or for a beneficiary or class of beneficiaries designated in the trust instrument; and (3) he is "independent" of the grantor of the trust, as described below. Thus, the power which an independent trustee may hold without being treated as a "beneficiary" under the trust is broader than the power which will be disregarded if held by other individuals in that, in the case of an independent trustee, allocations can be made among persons other than lineal descendants of the grantor.

For purposes of these rules, an independent trustee is an individual trustee who is not "related" or "subordinate." A trustee is treated as being related or subordinate if he or she is (1) a spouse of the grantor or of any beneficiary; (2) the father, mother, lineal descendant, brother, or sister of the grantor or of any beneficiary; (3) an employee of a corporation in which the stock holdings of the grantor, the trust, and all beneficiaries of the trust are "significant" (as defined under regulations) from the viewpoint of voting control; (4) an employee of a corporation in which the grantor or any beneficiary is an executive; (5) a partner of a partnership in which the interest of the grantor, the trust and all beneficiaries of the trust are "significant" from the viewpoint of operating control or distributive share of partnership income; or (6) an employee of a partnership in which the grantor or any beneficiary of the trust is a partner.

### ***Effective date***

This provision applies to any generation-skipping transfer made after June 11, 1976.

### ***Revenue effect***

This provision will have no effect on budget receipts.

**31. Clarification of Rules in a Generation-Skipping Trust Where a Beneficiary Has More Than One Power or Interest (sec. 702(n)(3) of the Act and sec. 2613(b)(2) of the Code)**

***Prior law***

Under present law, a termination of the rights of a beneficiary in a generation-skipping trust may constitute an event which gives rise to the imposition of a generation-skipping tax if the beneficiary is a younger-generation beneficiary of the trust and other younger-generation beneficiaries of the trust are in younger generations more remote from the grantor than the generation of the beneficiary whose interest terminates.

Present law provides that if a younger-generation beneficiary of a trust has both an interest and a power, or more than one interest or power, in the trust, termination with respect to each such interest or power is to be treated as occurring at the time when the last termination occurs, except in certain limited circumstances where the Treasury Department provides otherwise by regulations.

***Reasons for change***

The rules permitting postponement of a taxable termination where the same beneficiary holds more than one interest or power in a trust were provided to allow flexibility in the drafting of trust instruments by allowing the grantor to create powers or interests which could terminate without immediately triggering a tax. However, such a postponement rule is not appropriate where the remaining interests or power are merely future or contingent. Where all present interests and powers of a beneficiary have terminated, this should be treated as a taxable termination, even though he may hold a future interest. While there is authority under present law to deal with the problems of future or contingent interests by regulations,<sup>1</sup> it appears desirable to clarify the intent of Congress in these situations.<sup>2</sup>

***Explanation of provision***

The Act clarifies present law (sec. 2613(b)(2)(B)) so that the rule which postpones termination of a beneficiary's interest or powers in a generation-skipping trust until the termination of the last such interest or power applies to "present" interest and powers. Thus, the Act does not allow postponement where a present interest terminates and the beneficiary's remaining interests and powers are all future or contingent.

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<sup>1</sup> See H. Rept. 94-1380, p. 51 and n. 6.

<sup>2</sup> Other rules under the generation-skipping provisions generally insure that a tax will not be imposed twice with respect to transfers of the same trust in the same generation. Therefore, double taxation will not occur under this amendment, even if a beneficiary's future or contingent interest in the trust should later become a present interest which subsequently terminates.

***Effective date***

This provision applies to any generation-skipping transfer made after June 11, 1976.

***Revenue effect***

This provision will have no effect on budget receipts.

**32. Alternate Valuation in Certain Cases Where There Is a Taxable Termination at the Death of an Older-Generation Beneficiary (sec. 702(n)(4) of the Act and sec. 2602(d) of the Code)**

***Prior law***

Under present law, if a taxable termination occurs on the death of a younger-generation beneficiary, the assets subject to the generation-skipping tax may be valued either on the death of the younger-generation beneficiary or on the alternate valuation date with respect to his estate (sec. 2602(d)). However, if the taxable termination which would otherwise occur on the death of a younger-generation beneficiary is postponed because an older-generation beneficiary, such as the spouse of the grantor, has an interest in the generation-skipping trust, then the assets subject to the generation-skipping tax are to be valued as of the death of the older-generation beneficiary. No alternate valuation is permitted in such a case.

***Reasons for change***

The rules described above can result in unintended hardship under certain circumstances. Thus, for example, if a will provides that income of a trust is to be paid to the grantor's son for life, then to the grantor's widow for life, with the remainder to the grantor's great-grandchildren, and the son predeceases the widow, the generation-skipping tax is postponed until the death of the widow and the use of the alternate valuation date is not available under those circumstances. The Congress believes it is appropriate to allow an alternate valuation to be used in these cases.

***Explanation of provision***

The Act amends present law to provide that an alternate valuation date may be used to value the assets of a generation-skipping trust in cases where the death of an older-generation beneficiary causes a taxable termination. Thus, in such a situation, the assets may be valued either as of the date of the death of the older-generation beneficiary or on the appropriate alternate valuation date.

***Effective date***

This provision applies to any generation-skipping transfer made after June 11, 1976.

***Revenue effect***

This provision will have no effect on budget receipts.



### **33. Adjustment for Trust Accumulation Distribution Subject to Transfer Tax (sec. 702(o) of the Act and sec. 667 of the Code)**

#### ***Prior law***

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for Federal estate taxes attributable to appreciation. This adjustment is designed to prevent the imposition of an income tax on the portion of the estate taxes attributable to appreciation. Similarly, when property has been sold before death but the gain is recognized by the heirs for income tax purposes, the death taxes attributable to the gain are allowable as a separate deduction in computing the taxable income of the heirs (rather than as an adjustment to the basis of the property sold). In addition, similar adjustments are also permitted with respect to the generation-skipping tax imposed under the 1976 Act.

#### ***Reasons for change***

The Congress believes it is appropriate to provide for an adjustment having a similar income tax effect for distributions of accumulated income by a trust which had been subject to estate tax or the generation-skipping tax.

#### ***Explanation of provision***

The Act provides that the tax imposed on a beneficiary with respect to an accumulation distribution is to be adjusted to take into account the estate tax or generation-skipping tax attributable to the accumulated income. The effective date of the provision conforms to the effective date changes made by the Act to the carryover basis and generation-skipping transfer provisions.

#### ***Effective date***

This provision applies to the estates of decedents dying after December 31, 1979, for purposes of the estate tax and to any generation-skipping transfer made after June 11, 1976, for purposes of the generation-skipping tax.

#### ***Revenue effect***

This provision has no effect upon budget receipts.

**34. Reliance by an Executor on Information Furnished by the IRS Concerning the Decedent's Taxable Gifts Made After 1976 (sec. 702(p) of the Act and sec. 2204 of the Code)**

***Prior law***

The 1976 Act imposed a single unified progressive rate schedule on the basis of the cumulative lifetime and deathtime transfers. Under this system, the estate tax is dependent upon the lifetime transfers of the decedent. In addition, an executor must file an estate tax return where the gross estate exceeds \$120,000 (increasing to \$175,000 in the case of decedents dying after 1980) reduced by the taxable gifts made after 1976.

Thus, in order to compute the amount of estate tax for which the estate is liable, the executor must know the total amount of taxable gifts which had been made by the decedent after 1976. Although an executor can obtain copies of any tax return of the decedent, there is nothing in present law which relieves an executor from personal liability for any estate tax because of incorrect information contained in those returns or for gifts for which returns were not filed.

***Reasons for change***

The Congress understands that it is often difficult for executors to determine to whom the decedent had made taxable transfers during his lifetime. Because of this problem, the Congress believes that the executor should be permitted to rely upon the gift tax returns furnished to him by the IRS if his reliance is in good faith.

***Explanation of provision***

The Act relieves the executor from liability for additional estate taxes attributable to gifts not shown on a return (including gifts for which no return was filed) if the executor, in good faith, relied upon information furnished by the IRS concerning the taxable gifts made by the decedent after 1976. However, the executor is not relieved from liability for gifts made within three years of the decedent's death.

***Effective date***

This amendment is effective for decedents dying after December 31, 1976.

***Revenue effect***

This amendment will have no effect on budget receipts.

### **35. Public Indexing of Federal Tax Liens (sec. 702(q) of the Act and sec. 6323 of the Code)**

#### ***Prior law***

Generally, a Federal tax lien takes priority (with certain relatively limited exceptions) over interests in the property subject to the lien which are held by purchasers, holders of a security interest, mechanic's lienors and judgment lien creditors if notice of the tax lien has been appropriately filed before such interests are acquired. The 1976 Act provided that a notice of a lien is not to be treated as meeting the filing requirements unless a public index of the lien is maintained at the district Internal Revenue Service office in which the property subject to the lien is situated. For this purpose, an index of liens affecting real property would be maintained in the district office for the area in which the real property is physically located. In the case of liens affecting personal property, the index would be maintained in the district office for the area in which the residence of the taxpayer is located at the time the notice of lien is filed.

#### ***Reasons for change***

The requirement for public indexing of tax liens at the appropriate district Internal Revenue Service office has resulted in the imposition of a significant burden in searching titles in connection with real estate sales. A person searching a title has to check the records at the local courthouse and also at the district Internal Revenue Service office for Federal tax liens. In many instances, the district office will be located some considerable distance away. The Federal index will often duplicate an index already maintained at the State or local office.

For these reasons, the Congress believes that the Federal indexing requirement should be repealed and that a new indexing requirement should apply under applicable local law with respect to the indexing by the State or local office where notices of tax liens are filed rather than having the Internal Revenue Service maintain an index.

#### ***Explanation of provision***

The Act repeals the Federal indexing requirement. A new indexing requirement for the Federal tax lien would apply at the local level where the notices of tax lien are usually filed and would apply only with respect to real estate. The exclusion of personal property from the indexing requirement is consistent with the perfection-by-filing approach taken under the secured transactions article of the Uniform Commercial Code, which has been adopted by almost all States with respect to security interests in personal property.

In the case of real property, the new indexing requirement is to apply only if two conditions are met. First, State law must require public indexing of a deed to be valid against a purchaser of the property who does not have actual notice or knowledge. Thus, the Federal

tax lien is not to be singled out for an indexing requirement under the applicable State law when other interests are not required to be indexed for protection against subsequent purchasers. It is expected that Internal Revenue Service will issue rulings to advise the public as to its understanding of which States require indexing for protection against subsequent purchasers and which do not.

Second, the appropriate office where notices of tax lien are filed must have an adequate system for indexing of Federal tax liens. For this purpose, the system is not to be considered as adequate unless it is set up and maintained in such a way that a reasonable inspection of the index will reveal the existence of the tax lien. It would not be necessary to maintain both a tract index and an alphabetical taxpayer index if either one would satisfy this condition. However, the index could be considered inadequate if the local clerk responsible for indexing consistently fails to index within a reasonable time after notices of tax lien have been filed by the Service. If the indexing requirement would apply but for the indexing system subsequently becoming inadequate, it is expected that the Service will make a public announcement that it does not consider the system adequate so that title searchers will be on notice as to this position. However, the Service is expected to allow a reasonable period for a recording clerk to attempt to correct any deficiencies in a system before finally determining that the system is considered inadequate.

Where these conditions are satisfied, the priority of a tax lien against purchasers and other creditors will be determined by the reference to the time of indexing rather than the time of filing of the notice of tax lien. Purchasers and creditors who acquire their interests in the property subject to a tax lien before the notice of tax lien has been indexed will be protected against a previously filed tax lien.

### ***Effective date***

The amendments are to apply to liens, other security interests, and other interests in real property acquired after the date of the enactment of the Act. If, after the date of enactment, there is a change affecting the application of the indexing requirement (such as a change in State law relating to the necessity of indexing for protection against subsequent purchasers), the change is to apply only with respect to liens, other security interests, and other interests in real property acquired after the date of such change.

### ***Revenue effect***

These provisions will have no significant revenue effect.

**36. Clerical Amendments (sec. 702(r) of the Act and secs. 1016, 2051, 6324B and 6698 of the Code)**

Section 702(r) of the Act reflects a number of clerical amendments to the estate and gift tax provisions:

*Amendment of sec. 6698.* The 1976 Act added two new section 6694's. The section 6694 relating to failure to file information with respect to carryover basis property is redesignated as section 6698.

*Amendment of sec. 2051.* This provision deletes a reference to the estate tax exemption which was repealed by the 1976 Act.

*Amendment of sec. 1016.* The paragraph added by the 1976 Act as paragraph (23) of section 1016(a) is redesignated as paragraph (21).

*Amendment of sec. 6324B.* This provision corrects a reference in section 6324B to conform the term "qualified real property" to its definition in section 2032A.

## C. OTHER CLERICAL CORRECTIONS, CROSS REFERENCES, ETC.

### (Sec. 703 of the Act and various sections of the Code)

Section 703 of the Act reflects a number of clerical corrections and cross reference changes to the Tax Reform Act of 1976. Many of these changes are necessitated by the changes made by title XIX of the 1976 Act, popularly referred to as the "deadwood" provisions. These provisions deleted a number of little-used provisions and made many simplifying changes to the Code.

The following is a section-by-section explanation of the clerical and cross reference changes.

#### 1. Cross References Relating to the Investment Credit (sec. 703(a) of the Act and secs. 46 and 48 of the Code)

*a. Amendment of section 46(f)(8).*—The first sentence of section 46(f)(8) is amended to change the cross reference to subsection (a)(7)(D) of section 38 instead of subsection (a)(6)(D).

*b. Amendment of section 46(g)(5).*—The cross reference in section 46(g)(5) is corrected to the Merchant Marine Act, 1936 instead of the Merchant Marine Act, 1970.

*c. Amendment of section 48(d)(1)(B).*—The cross reference in section 48(d)(1)(B) is corrected to be section 46(a)(6) instead of section 46(a)(5).

*d. Amendment of section 48(d)(4)(D).*—The cross reference in section 48(d)(4)(D) is corrected to be section 57(c)(1)(B) instead of section 57(c)(2).

#### 2. Prepaid Legal Services (sec. 703(b) of the Act, section 2134(e) of the Tax Reform Act of 1976, and sec. 501(c)(20) of the Code)

*a.* The reference in section 2134(e) of the Tax Reform Act of 1976 is corrected to be section 120(d)(7) of the Code instead of section 120(d)(6).

*b.* A clerical change is made in section 501(c)(20) of the Code to delete the internal reference to "section 501(c)(20)" and instead refer simply to "this paragraph."

#### 3. Corrections Relating to Individual Retirement Account Provisions (sec. 703(c) of the Act and secs. 219, 220 and 408 of the Code)

*a. Amendment of section 219(c)(4).*—The reference in section 219(c)(4) is corrected to be subsection (b)(2)(A)(iv) instead of subsection (b)(3)(A)(iv).

*b. Amendment of section 220(b)(1)(A).*—This corrects a clerical error in section 220(b)(1)(A) of the Code.

*c. Amendment of section 220(b)(4).*—This clarifies the reference to "any payment" by indicating that it refers to "any payment described in subsection (a)" of section 220 of the Code.

*d. Amendment of section 408(d) (4).*—A clerical correction is made to section 1501(b) (5) of the Tax Reform Act of 1976 so that each reference in Code section 408(d) (4) to section 219 is also followed by “or 220” as was intended in the drafting of the Act.

**4. Accrual Accounting for Farm Corporations (sec. 703(d) of the Act and sec. 447 (a) and (g) (2) of the Code)**

A correction is made to sections 447 (a) and (g) (2) of the Code to refer to “preproductive period expenses” instead of to “preproductive expenses” in order to conform these references to the exact term as defined in section 447(b).

**5. Renumbering of Section 911(c) (sec. 703(e) of the Act and sec. 911(c) of the Code)**

A clerical change is made by renumbering paragraph (8) of section 911(c) as paragraph (7).<sup>1</sup>

**6. Transition Rule for Private Foundations (sec. 703(f) of the Act and sec. 101(l)(2)(F) of the Tax Reform Act of 1969)**

A modification of the 1969 Act’s transitional rule for sales of property by private foundations was made by section 1301(a) (3) of the Tax Reform Act of 1976. This provision of the bill corrects a clerical error made in that modification by inserting a comma in lieu of the period at the end of clause (i) of section 101(l) (2) (F) of the 1969 Act, as amended by the 1976 Act.

**7. Lobbying by Public Charities (sec. 703(g) of the Act and secs. 501, 4911, 6313, and 6405 of the Code)**

The bill makes a clerical change in the heading of the table setting forth the lobbying nontaxable amounts of public charities to reflect that the proper base for measuring such amounts is “exempt purpose expenditures.” The bill also makes technical amendments to section 501 of the Code (relating to exempt organizations) to correct clerical errors in the coordination of subsection designations by the Tax Reform Act of 1976 and Public Law 94-568.

**8. Amendments to Foreign Tax Provisions (sec. 703(h) of the Act and sec. 1035 of the Tax Reform Act of 1976 and sec. 999 of the Code)**

*a.* A clerical change is made to section 1035(c) (2) of the Tax Reform Act of 1976 to make it clear that the phrase “oil and gas extraction income” has the same meaning for purposes of that section as the meaning in section 907(c) of the Code.

*b.* The cross reference in section 999(c) (1) of the Code is corrected to be 995(b) (1) (F) (ii) rather than section 995(b) (3).

*c.* The cross reference in section 999(c) (2) of the Code is corrected to be section 995(b) (1) (F) (ii) instead of section 999(b) (1) (D) (ii).

**9. Amendments to DISC Provisions (sec. 703(i) of the Act and secs. 995 and 996 of the Code and sec. 1101 of the Tax Reform Act of 1976)**

*a.* The reference in section 995(b) (1) of the Code to “gross income (taxable income in the case of subparagraph (D))” is changed

<sup>1</sup> This provision was repealed by other legislation (section 202(e) of the Foreign Earned Income Act of 1978).

to refer simply to income. In addition, the reference to subparagraph (E) is corrected to be a reference to subparagraph (G).

b. The cross reference in section 996(a)(2) of the Code is corrected to be section 995(b)(1)(G) instead of section 995(b)(1)(E).

c. The cross reference in section 1101(g)(5) of the Tax Reform Act is corrected to be section 995(e)(3) instead of section 993(e)(3).

## **10. Clerical Amendments Relating to "Deadwood" Provisions (sec. 703(j) of the Act)**

### ***a. Tax-Exempt Governmental Obligations (sec. 703(j)(1) of the Act and sec. 103 of the Code)***

This paragraph provides a number of amendments to section 103 of the Code to conform to amendments made to section 103 by sections 1901(a)(17) and 2105 of the Tax Reform Act of 1976.

### ***b. Amendments Relating to Section 311(d)(2) (sec. 703(j)(2) of the Act and sec. 311(d)(2) of the Code)***

A clerical change is made to section 311(d)(2) by redesignating subparagraph (H) as subparagraph (G).

The cross references in section 2(b) of the Bank Holding Company Tax Act of 1977 to subparagraph (F) and subparagraph (b) are corrected to subparagraph (E) and subparagraph (F), respectively.

### ***c. Installment Method of Accounting (sec. 703(j)(3) of the Act and sec. 453 of the Code)***

This provision eliminates the effects of a deadwood change made to section 453 of the Code by section 1901(a)(66)(A) of the Tax Reform Act of 1976. The language in section 453 of the Code which was amended by the Tax Reform Act is considered obsolete and therefore can be deleted in its entirety.

### ***d. Definition of Life Insurance Company (sec. 703(j)(4) of the Act and sec. 801 of the Code)***

This amendment makes conforming changes to reflect the amendment of section 805 of the Code (relating to pension plan reserves) made by section 1901(a)(97)(C) of the 1976 Act. The Act deleted from section 805 an obsolete transitional rule and renumbered the remaining provisions, but failed to make a conforming change in section 801(g) of the Code (relating to contracts with reserves based on segregated asset accounts). Accordingly, the bill deletes from section 801(g)(1)(B)(ii) and (7) the references to "subparagraph (A), (B), (C), (D), or (E) of section 805(d)(1)" and substitutes a reference to any paragraph of section 805(d).

### ***e. Amendment of section 1033(a)(2)(A) (sec. 703(j)(5) of the Act and sec. 1033(a)(2)(A) of the Code)***

The cross reference in section 1033(a)(2)(A) is corrected to section 1033(b) instead of section 1033(c).

### ***f. Amendment of section 1375(a)(2) (sec. 703(j)(6) of the Act and sec. 1375(a)(2) of the Code)***

Section 1375(a)(2) is corrected by changing the term "such excess" to "such gain".



***g. Amendment of section 1561(b)(3) (sec. 703(j)(7) of the Act and sec. 1561(b)(3) of the Code)***

The reference in section 1561(b)(3) is corrected to section "804(a)(3)" instead of "804(a)(4)".

***h. Definitions Relating to the Tax on Self-Employment Income (sec. 703(j)(8) of the Act and sec. 1402 of the Code)***

This provision makes two clerical amendments to section 1402 of the Code to conform to the amendment made to section 1402 by section 1901(a)(155)(B) of the Tax Reform Act of 1976.

***i. Computing the Amount of the Investment Credit (sec. 703(j)(9) of the Act and sec. 46 of the Code)***

This provision amends section 1901(b)(1)(C) of the Tax Reform Act of 1976 to conform to an amendment made by section 802(a)(1) of that Act. Section 1901(b)(1)(C) of the Act made an amendment to section 46(a)(3) of the Code, but that amendment should have been made to section 46(a)(4) of the Code, inasmuch as section 46(a)(3) was redesignated as section 46(a)(4) by section 802(a)(1) of the Act. This provision of the bill amends section 1901(b)(1)(C) of the Act to make it refer, as it should, to section 46(a)(4) of the Code.

***j. Cross Reference (sec. 703(j)(10) of the Act and secs. 6504 and 6515 of the Code)***

This provision corrects a typographical error made in section 1901(b)(37)(D) of the Tax Reform Act of 1976.

***k. Special Tax Rules Affecting Territories (sec. 703(j)(11) of the Act and sec. 37 of the Code)***

This provision repeals section 1901(c)(1) of the Tax Reform Act of 1976. That provision of the Tax Reform Act, which amended section 37(f) of the Code by eliminating an obsolete reference to a "Territory," was made superfluous by a substantive amendment made to that same section of the Code by section 503(a) of the Tax Reform Act.

***l. Effective Dates of Tax Reform Estate and Gift Tax Amendments (sec. 703(j)(12) of the Act and sec. 1902(c) of the Tax Reform Act of 1976)***

This provision corrects a group of clerical errors in section 1902(c) (providing effective dates for the "Deadwood" estate and gift tax amendments) of the Tax Reform Act of 1976. These errors resulted because the effective date provisions for the estate and gift tax amendments of the Code made by Title XIX of the Tax Reform Act (the so-called Deadwood amendments) were not conformed to amendments to the same estate and gift tax sections of the Code made by other titles of the Act.

***m. Tax on Excess Retirement Plan Contributions (sec. 703(j)(13) of the Act and sec. 4973(a) of the Code)***

This deletion is necessary because the Tax Reform Act erroneously gave section 1904(a)(22)(A) of the Act, which provided a technical amendment to section 4973(a) of the Code, an effective date that was subsequent to the effective date of section 1501(b)(8) of the Act,

which made a substantive change to that same section of the Code. As a result, except for this provision of the bill, the technical correction language of section 1904(a)(22)(A) of the Act would replace the more complete amendment made to section 4973(a) of the Code by section 1501(b)(8) of the Act. This provision of the bill advances the effective date of the language of section 1904(a)(22)(A) of the Act thereby leaving in place the amendment made by section 1501(b)(8) of the Act.

***n. Social Security Act Amendments (sec. 703(j)(14) of the Act and secs. 202, 205, 210, and 211 of the Social Security Act)***

This provision makes a number of amendments to sections of the Social Security Act to conform to several amendments made to the Internal Revenue Code by the Tax Reform Act of 1976.

**11. Capital Loss Carryover (sec. 703(k) of the Act and sec. 1212 of the Code)**

This provision corrects the phrase "exceeding the loss year" to read "succeeding the loss year."

**12. Aircraft Museums (sec. 703(l) of the Act and secs. 4041, 6427, and 7609 of the Code)**

This amendment makes several clerical and conforming changes arising under P.L. 94-530, which provides an exemption from the fuel and aircraft use excise taxes for certain aircraft museums. A clerical change is made to insert an omitted word in section 4041(h)(2), added by P.L. 94-530. In addition, conforming changes are made to correct cross references in section 4041 and other Code provisions, and to conform the aircraft museum amendments with changes made by the deadwood provisions of the Tax Reform Act of 1976.

**13. Inspection of Returns by Congress (sec. 703(m) of the Act and sec. 6104 of the Code)**

This provision corrects a cross reference in section 6104 to section 6103.

**14. Limitation on Assessment and Collection (sec. 703(n) of the Act and sec. 6501 of the Code)**

This provision corrects a reference in section 6501 to section 6213(b)(3).

**15. Conforming Amendment Regarding Definition of Taxable Income (sec. 703(o) of the Act and sec. 443(b) of the Code)**

Section 443(b) is amended to conform that section to the amendment to the redefinition of the term "taxable income" by the Tax Simplification and Reduction Act of 1977.

**16. Conforming Amendment to Section 172 (sec. 703(p) of the Act and secs. 172(b)(3)(A), 6501(h) and 6511(d)(2)(A) of the Code)**

Section 172(b)(3)(A) is amended to conform that section to the repeal of section 317 of the Trade Expansion Act of 1962.

**17. Tax-Exempt Bonds for Student Loans (sec. 703(q) of the Act and sec. 103(c) of the Code)**

The reference in section 103(c) (5) of the Code relates to the Emergency Insured Student Loan Act of 1969, which Act was repealed on October 12, 1976, and succeeded by similar provisions contained in the Education Amendments of 1976 (P.L. 94-482). This reference is deleted and replaced by the appropriate reference to the statute as amended by the Education Amendments of 1976.



## **TITLE VIII—AMENDMENTS TO THE SOCIAL SECURITY ACT**

### **1. Grants to States for Social Services (sec. 801 of the Act)**

#### ***Prior law***

In addition to providing Federal funding for cash public assistance to certain categories of needy individuals, the welfare titles of the Social Security Act have provided funding for a variety of social services programs. Originally, the costs of social services were considered a part of the administrative costs of operating cash public assistance programs, but subsequent amendments provided separate recognition of social services programs, expanded their availability to persons not receiving cash assistance, permitted funding of services provided by other than the welfare agency itself (including services by non-public agencies), and increased the Federal rate of matching to 75 percent (90 percent in the case of family planning services).

Prior to fiscal year 1973, Federal matching for social services, like Federal matching for welfare payments, was open-ended. Every dollar a State spent for social services was matched by three Federal dollars. In 1971 and 1972 particularly, States made use of these provisions to increase at a rapid rate the amount of Federal money going into social services programs.

In 1972, the Congress established a \$2.5 billion annual ceiling on the amount of Federal funding for social services programs effective for fiscal year 1973 and subsequent fiscal years. Under this overall national ceiling, each State has a ceiling established which is based on its population relative to the population of the entire Nation.

In 1974, Congress substantially revised the statutes governing the social services programs. The 1974 legislation consolidated the provisions governing social services programs under the Social Security Act in a new separate services title (title XX). The Federal matching percentage for services remained at 75 percent (90 percent for family planning) under the new title XX program, and the overall ceiling of \$2.5 billion allocated among the States on a population basis was not changed.

#### ***Reasons for change***

The amount of the general title XX spending ceiling has not been increased since 1972. The only additional funding which has been available to the States for social services has been earmarked for child care services. The 94th and 95th Congresses authorized \$200 million for child care for each of fiscal years 1977 and 1978.

Since the implementation of title XX in 1975, many States have undertaken to revise and strengthen their social services programs. Efforts have been made to expand the variety of services offered and to

expand eligibility to a broader segment of the population. The result has been that although only 25 States were spending all or nearly all of their full allocation under title XX in fiscal year 1976, 41 States are at or near their spending ceiling at the present time. The following table shows the growth in utilization of title XX funds in recent years.

### EXTENT OF STATE UTILIZATION OF AVAILABLE TITLE XX FUNDING, FISCAL YEARS 1976-1978

[Number of States]

Fiscal year	98 to 100 percent of ceiling	90 to 98 percent of ceiling	80 to 90 percent of ceiling	Less than 80 percent of ceiling	Federal cost (000)
1976.....	18	7	9	17	\$2,130,380
1977 <sup>1</sup> .....	19	14	9	9	2,259,726
1978 <sup>1</sup> .....	35	6	6	4	2,382,604

<sup>1</sup> Estimated. fiscal 1977 and 1978 data reflect only expenditures under the permanent \$2.5 billion ceiling.

Source: Fiscal 1979 budget estimates, Department of Health, Education, and Welfare.

#### *Explanation of provision*

The Act extends the temporary \$200 million additional amount for one more year—through fiscal year 1979. As was the case in fiscal years 1977 and 1978, this \$200 million requires no non-Federal match. To qualify for their entire share of this \$200 million, States must spend at least equal to that share for title XX child care services. The Act also provides a further \$200 million increase in the ceiling for fiscal 1979 which is available for social services generally and subject to the ordinary matching requirements of the title XX.

The net effect of this provision is to raise the ceiling on Federal funding for title XX social services to \$2.9 billion for fiscal year 1979. After fiscal year 1979, the ceiling will revert to its permanent level of \$2.5 billion in the absence of further legislation.

The following table shows how the funds made available under the Act are allocated.

FISCAL 1979 CEILING ON FEDERAL MATCHING FUNDS FOR  
SOCIAL SERVICES UNDER TITLE XX

[In thousands]

State	Ceiling applicable to expenditures:	
	For title XX generally	Additional child care amount
Total .....	\$2,700,000	\$200,000
Alabama .....	48,099	3,415
Alaska .....	4,805	356
Arizona .....	28,552	2,115
Arkansas .....	26,527	1,965
California .....	270,682	20,051
Colorado .....	32,489	2,407
Connecticut .....	39,206	2,904
Delaware .....	7,321	542
District of Columbia .....	8,830	654
Florida .....	105,921	7,846
Georgia .....	62,513	4,631
Hawaii .....	11,157	827
Idaho .....	10,452	774
Illinois .....	141,240	10,462
Indiana .....	66,689	4,940
Iowa .....	36,099	2,674
Kansas .....	29,056	2,152
Kentucky .....	43,118	3,194
Louisiana .....	48,313	3,579
Maine .....	13,459	997
Maryland .....	52,124	3,861
Massachusetts .....	73,067	5,412
Michigan .....	114,511	8,482
Minnesota .....	49,872	3,694
Mississippi .....	29,609	2,193
Missouri .....	60,098	4,452
Montana .....	9,471	702
Nebraska .....	19,534	1,447
Nevada .....	7,673	568
New Hampshire .....	10,339	766
New Jersey .....	92,273	6,835
New Mexico .....	14,691	1,088
New York .....	227,463	16,849
North Carolina .....	68,790	5,096
North Dakota .....	8,088	599

# FISCAL 1979 CEILING ON FEDERAL MATCHING FUNDS FOR SOCIAL SERVICES UNDER TITLE XX—Continued

[In thousands]

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Ohio.....	134,460	9,960
Oklahoma.....	34,791	2,577
Oregon.....	29,295	2,170
Pennsylvania.....	149,202	11,052
Rhode Island.....	11,660	864
South Carolina.....	35,823	2,654
South Dakota.....	8,629	639
Tennessee.....	53,004	3,926
Texas.....	157,063	11,634
Utah.....	15,446	1,144
Vermont.....	5,987	444
Virginia.....	63,293	4,688
Washington.....	45,432	3,365
West Virginia.....	22,905	1,697
Wisconsin.....	57,973	4,294
Wyoming.....	4,906	363

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Source: Federal Register, Feb. 1 and 16, 1979.

***Effective date***

The provisions of this section are effective for the fiscal year October 1, 1978 through September 30, 1979.

***Budgetary impact***

The Act increases the amount of Federal funding available for fiscal year 1979 by \$400 million. Since some States do not fully use the funding available within their individual ceilings, it is expected that the actual impact on budget authority and outlays for fiscal 1979 will be an increase, compared with prior law, of approximately \$0.3 billion.



## 2. Changes in Public Assistance Matching Formula, and Increase in Amount of Public Assistance Dollar Limitations, for Puerto Rico, the Virgin Islands, and Guam in Fiscal Year 1979 (sec. 802 of the Act)

### *Prior law*

Under the Social Security Act, public assistance programs of aid and services to the aged, blind, and disabled, and to families with dependent children are operated in Puerto Rico, the Virgin Islands, and Guam in accordance with State plans for these programs developed by the territories and approved by the Department of Health, Education, and Welfare. The costs incurred by the territories in carrying out those plans are partially reimbursed by the Federal Government according to a matching formula and funding ceiling specified in the law. Under permanent law the matching formula provides for 50 percent Federal participation up to a maximum per fiscal year of \$24 million in Puerto Rico, \$800,000 in the Virgin Islands, and \$1.1 million in Guam.

### *Reasons for change*

The prior law limitations on Federal funding for territorial assistance programs have been in effect since 1972. It is believed that these limitations have contributed to an undesirably low level of assistance for all categories of recipients in these jurisdictions. The changes provided for in the Act will make it possible for the territories to double the size of their federally matched assistance under these programs with no increase in the non-Federal share of the costs.

### *Explanation of provision*

Under the Act, the rate of Federal matching for the costs of public assistance programs in Puerto Rico, the Virgin Islands, and Guam will be increased for fiscal year 1979 from 50 percent to 75 percent. The overall limitation on the amount of Federal funding for these programs will be tripled in fiscal 1979 as shown in the table below.

### FEDERAL FUNDS FOR TERRITORIAL ASSISTANCE PROGRAMS

	Permanent law (50 percent Federal matching)	Fiscal 1979 (75 percent Federal matching)
Puerto Rico.....	\$24,000,000	\$72,000,000
Virgin Islands.....	800,000	2,400,000
Guam.....	1,100,000	3,300,000

***Effective date***

The provision is effective for the fiscal year October 1, 1978–September 30, 1979. As of October 1, 1979, the matching rate and dollar limits will, in the absence of further legislation, revert to the permanent law levels as indicated in the above table.

***Budgetary impact***

It is estimated that the provision will increase budget authority and outlays for fiscal year 1979 by approximately \$50 million.

## APPENDIX

### NEW INDIVIDUAL INCOME TAX RATE SCHEDULES UNDER THE REVENUE ACT OF 1978

**RATE REDUCTION.**—Section 1 of the Code (relating to tax imposed) is amended to read as follows:

**“SECTION 1. TAX IMPOSED.**

**“(a) Married Individuals Filing Joint Returns and Surviving Spouses.**—There is hereby imposed on the taxable income of—

“(1) every married individual (as defined in section 143) who makes a single return jointly with his spouse under section 6013, and

“(2) every surviving spouse (as defined in section 2(a)), a tax determined in accordance with the following table:

<b>“If taxable income is:</b>	<b>The tax is:</b>
Not over \$3,400-----	No tax.
Over \$3,400 but not over \$5,500-----	14% of excess over \$3,400.
Over \$5,500 but not over \$7,600-----	\$294 plus 16% of excess over \$5,500.
Over \$7,600 but not over \$11,900-----	\$630, plus 18% of excess over \$7,600.
Over \$11,900 but not over \$16,000----	\$1,404, plus 21% of excess over \$11,900.
Over \$16,000 but not over \$20,200----	\$2,265, plus 24% of excess over \$16,000.
Over \$20,200 but not over \$24,600----	\$3,273, plus 28% of excess over \$20,200.
Over \$24,600 but not over \$29,900----	\$4,505, plus 32% of excess over \$24,600.
Over \$29,900 but not over \$35,200----	\$6,201, plus 37% of excess over \$29,900.
Over \$35,200 but not over \$45,800-----	\$8,162, plus 43% of excess over \$35,200.
Over \$45,800 but not over \$60,000----	\$12,720, plus 49% of excess over \$45,800.
Over \$60,000 but not over \$85,600----	\$19,678, plus 54% of excess over \$60,000.
Over \$85,600 but not over \$109,400----	\$33,502, plus 59% of excess over \$85,600.
Over \$109,400 but not over \$162,400--	\$47,544, plus 64% of excess over \$109,400.
Over \$162,400 but not over \$215,400--	\$81,464, plus 68% of excess over \$162,400.
Over \$215,400-----	\$117,504, plus 70% of excess over \$215,400.

**“(b) Heads of Households.**—There is hereby imposed on the taxable income of every individual who is the head of a household (as defined in section 2(b)) a tax determined in accordance with the following table:

**"If taxable income is:**

Not over \$2,300-----
Over \$2,300 but not over \$4,400-----
Over \$4,400 but not over \$6,500-----
Over \$6,500 but not over \$8,700-----
Over \$8,700 but not over \$11,800-----
Over \$11,800 but not over \$15,000---
Over \$15,000 but not over \$18,200---
Over \$18,200 but not over \$23,500---
Over \$23,500 but not over \$28,800---
Over \$28,800 but not over \$34,100---
Over \$34,100 but not over \$44,700---
Over \$44,700 but not over \$60,600---
Over \$60,600 but not over \$81,800---
Over \$81,800 but not over \$108,300--
Over \$108,300 but not over \$161,300--
Over \$161,300-----

**The tax is:**

No tax.
14% of excess over \$2,300.
\$294, plus 16% of excess over \$4,400.
\$630, plus 18% of excess over \$6,500.
\$1,026, plus 22% of excess over \$8,700.
\$1,708, plus 24% of excess over \$11,800.
\$2,476, plus 26% of excess over \$15,000.
\$3,308, plus 31% of excess over \$18,200.
\$4,951, plus 36% of excess over \$23,500.
\$6,859, plus 42% of excess over \$28,800.
\$9,085, plus 46% of excess over \$34,100.
\$13,961, plus 54% of excess over \$44,700.
\$22,547, plus 59% of excess over \$60,600.
\$35,055, plus 63% of excess over \$81,800.
\$51,750, plus 68% of excess over \$108,300.
\$87,790, plus 70% of excess over \$161,300.

**“(c) Unmarried Individuals (Other Than Surviving Spouses and heads of Households).—**There is hereby imposed on the taxable income of every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 143) a tax determined in accordance with the following table:

<b>“If taxable income is:</b>	<b>The tax is:</b>
Not over \$2,300-----	No tax.
Over \$2,300 but not over \$3,400-----	14% of excess over \$2,300.
Over \$3,400 but not over \$4,400-----	\$154, plus 16% of excess over \$3,400.
Over \$4,400 but not over \$6,500-----	\$314, plus 18% of excess over \$4,400.
Over \$6,500 but not over \$8,500-----	\$692, plus 19% of excess over \$6,500.
Over \$8,500 but not over \$10,800-----	\$1,072, plus 21% of excess over \$8,500.
Over \$10,800 but not over \$12,900-----	\$1,555, plus 24% of excess over \$10,800.
Over \$12,900 but not over \$15,000-----	\$2,059, plus 26% of excess over \$12,900.
Over \$15,000 but not over \$18,200-----	\$2,605, plus 30% of excess over \$15,000.
Over \$18,200 but not over \$23,500-----	\$3,565, plus 34% of excess over \$18,200.
Over \$23,500 but not over \$28,800-----	\$5,367, plus 39% of excess over \$23,500.
Over \$28,800 but not over \$34,100-----	\$7,434, plus 44% of excess over \$28,800.
Over \$34,100 but not over \$41,500-----	\$9,766, plus 49% of excess over \$34,100.
Over \$41,500 but not over \$55,300-----	\$13,392, plus 55% of excess over \$41,500.
Over \$55,300 but not over \$81,800-----	\$20,982, plus 63% of excess over \$55,300.
Over \$81,800 but not over \$108,300-----	\$37,687, plus 68% of excess over \$81,800.
Over \$108,300-----	\$55,697, plus 70% of excess over \$108,300.

**“(d) Married Individuals Filing Separate Returns.**—There is hereby imposed on the taxable income of every married individual (as defined in section 143) who does not make a single return jointly with his spouse under section 6013 a tax determined in accordance with the following table:

<b>“If taxable income is:</b>	<b>The tax is:</b>
Not over \$1,700-----	No tax.
Over \$1,700 but not over \$2,750-----	14% of excess over \$1,700.
Over \$2,750 but not over \$3,800-----	\$147, plus 16% of excess over \$2,750.
Over \$3,800 but not over \$5,950-----	\$315, plus 18% of excess over \$3,800.
Over \$5,950 but not over \$8,000-----	\$702, plus 21% of excess over \$5,950.
Over \$8,000 but not over \$10,100-----	\$1,132.50, plus 24% of excess over \$8,000.
Over \$10,100 but not over \$12,300----	\$1,636.50, plus 28% of excess over \$10,100.
Over \$12,300 but not over \$14,950----	\$2,252.50, plus 32% of excess over \$12,300.
Over \$14,950 but not over \$17,600----	\$3,100.50, plus 37% of excess over \$14,950.
Over \$17,600 but not over \$22,900----	\$4,081, plus 43% of excess over \$17,600.
Over \$22,900 but not over \$30,000----	\$6,360, plus 49% of excess over \$22,900.
Over \$30,000 but not over \$42,800----	\$9,839, plus 54% of excess over \$30,000.
Over \$42,800 but not over \$54,700----	\$16,751, plus 59% of excess over \$42,800.
Over \$54,700 but not over \$81,200----	\$23,772, plus 64% of excess over \$54,700.
Over \$81,200 but not over \$107,700---	\$40,732, plus 68% of excess over \$81,200.
Over \$107,700-----	\$58,752, plus 70% of excess over \$107,700.

**“(e) Estates and Trusts.**—There is hereby imposed on the taxable income of every estate and trust taxable under this subsection a tax determined in accordance with the following table:

<b>“If taxable income is:</b>	<b>The tax is:</b>
Not over \$1,050-----	14% of taxable income.
Over \$1,050 but not over \$2,100-----	\$147, plus 16% of excess over \$1,050.
Over \$2,100 but not over \$4,250-----	\$315, plus 18% of excess over \$2,100.
Over \$4,250 but not over \$6,300-----	\$702, plus 21% of excess over \$4,250.
Over \$6,300 but not over \$8,400-----	\$1,132.50, plus 24% of excess over \$6,300.
Over \$8,400 but not over \$10,600-----	\$1,636.50, plus 28% of excess over \$8,400.
Over \$10,600 but not over \$13,250-----	\$2,252.50, plus 32% of excess over \$10,600.
Over \$13,250 but not over \$15,900-----	\$3,100.50, plus 37% of excess over \$13,250.
Over \$15,900 but not over \$21,200-----	\$4,081, plus 43% of excess over \$15,900.
Over \$21,200 but not over \$28,300-----	\$6,360, plus 49% of excess over \$21,200.
Over \$28,300 but not over \$41,100-----	\$9,839, plus 54% of excess over \$28,300.
Over \$41,100 but not over \$53,000-----	\$16,751, plus 59% of excess over \$41,100.
Over \$53,000 but not over \$79,500-----	\$23,772, plus 64% of excess over \$53,000.
Over \$79,500 but not over \$106,000---	\$40,732, plus 68% of excess over \$79,500.
Over \$106,000-----	\$58,752, plus 70% of excess over \$106,000.”.

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