[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS (H.R. 677, H.R. 1607, H.R. 2568, H.R. 3030, and H.R. 3529)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON NOVEMBER 3, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on November 3, 1983, by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means.

The five bills scheduled for the hearing are H.R. 677 (relating to tax exclusion for value of certain employee lodging furnished by educational institutions prior to 1984); H.R. 1607 (treatment of certain motor vehicle operating agreements as leases); H.R. 2568 (extend exclusion for certain educational assistance programs); H.R. 3030 (exclusion for certain unemployment compensation paid in 1979); and H.R. 3529 (modify the tax treatment of regulated investment companies).

The first part of the pamphlet is a summary of the bills. This is followed in the second part by a more detailed description of the bills, including present law, explanation of provisions, and effective dates.

I. SUMMARY

1. H.R. 677—Messrs. Shannon, Conable, Duncan, Anthony, and Frenzel, and others

Tax Exclusion for Value of Certain Employee Lodging Furnished by Educational Institutions Prior to 1984

Present law (Code sec. 119) excludes from an employee's gross income the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment. Several court decisions have held that on-campus housing furnished to faculty by an educational institution did not satisfy the section 119 requirements, and hence that the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes.

The bill would provide an exclusion, for income and employment tax purposes, for the value of certain lodging furnished by, or on behalf of, schools, colleges, and universities to employees (or the employee's spouse or dependents). The bill would apply if (1) the lodging is located on a campus of, or in the proximity of, the educational institution and (2) the employee pays a reasonable rent that is not less than the necessary direct costs paid or incurred by the institution in providing the lodging. The bill would apply retroactively to taxable years or periods beginning before 1984.

2. H.R. 1607—Messrs. Gibbons, Matsui, Jacobs, Vander Jagt, Anthony, Frenzel, Fowler, Shannon, Hance, Archer, Duncan, Flippo, Guarini, Gradison, Philip M. Crane, Ford (Tenn.), Martin (N.C.), and Campbell, and others

Treatment of Certain Motor Vehicle Operating Agreements as Leases

Under present law, a case-by-case analysis of all relevant facts and circumstances is made to determine whether a transaction involving depreciable property is a lease. If the transaction is a lease, the lessor of the property is the owner for Federal income tax purposes and is entitled to ACRS deductions and investment credits. If the transaction is a financing arrangement or conditional sale, the user is considered the owner for tax purposes.

Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the presence of a terminal rental adjustment clause in a motor vehicle lease was taken into account in determining whether the nominal lessor would be treated as the owner. (A terminal rental adjustment clause permits or requires an upward or downward adjustment of rent to make up for any difference between the projected value of a vehicle and the actual value upon lease termination.) Section 210 of TEFRA prevents the Internal Revenue Service from retroactively denying lease treatment for certain motor vehicle leases by reason of the presence of a terminal rental adjustment clause. This provision is limited to operating leases in which the vehicle is used by the lessee for business purposes. After the enactment of TEFRA, the Internal Revenue Service issued proposed regulations which would deny lease treatment, on a prospective basis, for a motor vehicle agreement that contains a terminal rental adjustment clause.

The bill would provide that the presence of a terminal rental adjustment clause in a motor vehicle operating agreement is not to be taken into account in determining whether the agreement is a lease, regardless of whether the vehicle is used by the lessee for business or personal purposes. The amendment made by the bill would apply to motor vehicle operating agreements entered into before or after enactment of the bill.

3. H.R. 2568—Messrs. Shannon, Frenzel, Matsui, Jenkins, Thomas (Calif.), and Rangel, and others

Extend Exclusion for Certain Educational Assistance Programs

Under present law, an employee's gross income does not include amounts paid or expenses incurred by the employer for educational assistance provided to the employee pursuant to a program that meets certain requirements (Code sec. 127). This exclusion is to expire for taxable years beginning after 1983.

The bill would make permanent the section 127 exclusion for certain educational assistance programs.

4. H.R. 3030—Mr. Schulze

Exclusion for Certain Unemployment Compensation Paid in 1979

Prior to the Revenue Act of 1978, the Internal Revenue Service determined in a series of rulings that unemployment compensation paid under most government programs was excludable from gross income. The 1978 Act made includible a portion of unemployment compensation benefits paid pursuant to government programs to taxpayers with substantial other income during the year, effective for payments of unemployment compensation made after 1978 (Code sec. 85). Thus, benefits paid after 1978 may be subject to income tax even if attributable to periods of unemployment before 1978.

The bill would amend the Revenue Act of 1978 to provide that the provisions of that statute making includible in income a portion of unemployment compensation benefits would not apply to unemployment compensation (1) paid by reason of a work stoppage which began on March 19, 1973 and ended before July 19, 1973, and (2) paid in 1979 after the employer's appeal to the U.S. Supreme Court was dismissed on April 2, 1979, and its petition for rehearing denied on May 21, 1979. The bill would also extend until one year after its enactment the period for claiming any credit or refund, attributable to provisions of the bill, which would otherwise be prevented by another rule of law (including res judicata).

The intended beneficiaries of the bill are understood to be individuals represented (or formerly represented) in collective bargaining by Local (8)-901 of the Oil, Chemical, and Atomic Workers International Union, located in Marcus Hook, Pennsylvania, who were paid unemployment compensation in 1979 by reason of the 1973 work stoppage described above.

5. H.R. 3529—Mrs. Kennelly and Mr. Heftel

Modify the Tax Treatment of Regulated Investment Companies

The bill would modify the definition of a regulated investment company (RIC) to permit a personal holding company to qualify as a RIC under certain conditions. In the case of any RIC which was closely held, any undistributed investment company taxable income of the RIC would be taxed at the highest corporate rate. This provision would be effective for taxable years beginning after 1982.

Also, the bill would permit a RIC to elect to be taxed on original discount accruing with respect to any short-term government obligation as it accrues. This provision would be effective retroactively for taxable years beginning after 1978.

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II. DESCRIPTION OF THE BILLS

1. H.R. 677—Messrs. Shannon, Conable, Duncan, Anthony, and Frenzel, and others

Tax Exclusion for Value of Certain Employee Lodging Furnished by Educational Institutions Prior to 1984

Present Law

Present law (Code sec. 119) excludes from an employee's gross income the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment. Several court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution did not satisfy the section 119 requirements, and hence that the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes.[1]

Explanation of the Bill

The bill would provide an exclusion, for income and employment tax purposes, for the value of qualified campus lodging furnished by, or on behalf of, an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)) [2] for taxable years or periods beginning before 1984. The exclusion would apply to the value of such lodging furnished to any employee of the educational institution (or to the employee's spouse or dependents), including non-faculty employees.

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[1] *Bob Jones Univ.* v. *U.S.*, 670 F.2d 167 (Ct. Cl. 1982); *Goldsboro Christian Schools, Inc.* v. *U.S.*, 79-1 CCH USTC para. 9266, E.D.N.C. 1978 (value of lodging furnished to faculty constitutes wages subject to income tax, FICA, and FUTA withholding, in light of "long and consistent history of regulations and rulings, expressly and explicitly applying withholding taxes to lodging not furnished for the employer's convenience***"), *aff'g* order entered in *Goldsboro Christian Schools, Inc.* v. *U.S.*, 436 F.Supp. 1314 (E.D.N.C. 1977), *aff'd per curiam* in unpublished opinion (4th Cir. 1981), *aff'd* 103 S. Ct. 2017 (1983)); *Winchell* v. *U.S.*, 564 F.Supp. 131 (D. Neb. 1983) (value of campus home taxed to college president); and *Coulbourn H. Tyler*, 44 CCH Tax Ct. Mem. 1221 (1982).

Public Law 98-63, making supplemental appropriations for fiscal year 1983, prohibited the Internal Revenue Service from using any funds appropriated under that statute "to enforce any ruling which would subject to tax under subtitles A and C of the Internal Revenue Code of 1954 the value of campus lodging furnished by, or on behalf of, any educational institution described in section 170(b)(1)(A)(ii) of such Code to any employee of such institution or any spouse or dependent (within the meaning of section 152 of such Code) of such employee, or to conduct any other activity with respect to the assessment or collection of any such tax on such value".

[2] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities," and includes both public and private schools (Treas. Reg. sec. 1.170A-9(b)(1)).

The bill would apply only if (1) the employer-furnished lodging is located on a campus of, or in the proximity of, the educational institution and (2) the employee pays a reasonable rent that is not less than the necessary direct costs paid or incurred by the institution in providing the lodging.

Under the bill, the determination of whether a rental amount is reasonable would take into account factors such as the necessary direct costs of the institution furnishing the lodging, the value of the lodging to the employee to whom the lodging is furnished, and any educational purposes of the institution in furnishing the lodging. The bill would provide that a rent is not to be considered unreasonable solely because the rent is less than the fair rental value of the lodging.

Under the bill, in any case in which lodging provided to an employee (or the employee's spouse or dependents) would constitute qualified campus lodging but for the fact that the rent received is less than the necessary direct costs of the educational institution, only the excess of (1) the amount of the necessary direct costs over (2) the rent paid with respect to the lodging would be includible in the employee's gross income and would constitute wages for income tax withholding and FICA and FUTA tax purposes.

Effective Date

The provisions of the bill would apply retroactively for taxable years or periods beginning before January 1, 1984.

2. H.R. 1607—Messrs. Gibbons, Matsui, Jacobs, Vander Jagt, Anthony, Frenzel, Fowler, Shannon, Hance, Archer, Duncan, Flippo, Guarini, Gradison, Philip M. Crane, Ford (Tenn.), Martin (N.C.), and Campbell, and others

Treatment of Certain Motor Vehicle Operating Agreements as Leases

Present Law

General rules

Cost recovery (ACRS) deductions and investment credits are allowed for property that is used for a business or other income-producing purpose. These tax benefits generally are allowed only to the person who is, in substance, the owner of the property.

If the property is used in a transaction that is considered a lease for Federal income tax purposes, the lessor is treated as the owner entitled to ACRS deductions and investment credits. If the property is used in a transaction that is considered a financing arrangement or conditional sale, the user of the property is considered the owner for tax purposes.

In general, the determination of whether a transaction is a lease or a conditional sale requires a case-by-case analysis of all facts and circumstances. Although the determination of whether a transaction is a lease is inherently factual, a series of general principles has been developed in court cases, revenue rulings, and revenue procedures. Under these general principles, the lessor must show that the property is being used for a business or other income-producing purpose. To establish a business or other income-producing purpose, the lessor must have a reasonable expectation of deriving a profit from the transaction, independent of tax benefits.[3] This requirement precludes lease treatment for a transaction that is intended merely to reduce the user's costs by utilizing the lessor's tax base.

However, the fact that the lessor can show a business or other income-producing purpose does not automatically result in lease treatment, since a profit motive also exists in a financing arrangement. In addition, the lessor has to retain meaningful benefits and burdens of ownership.[4] Thus, lease treatment may be denied if the user of the property has an option to purchase the property at the end of the lease for a price that is nominal in relation to the value of the property at the time of exercise (as determined at the time the parties entered into the transaction), or for a price that is relatively small when compared with the total payments required to be made.[5]

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[3] *See Hilton* v. *Comm'r*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).
[4] *See Frank Lyon Co.* v. *U.S.*, 435 U.S. 561 (1978), *rev'g*, 536 F.2d 746 (8th Cir. 1976).
[5] *See* Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

If the residual value to the lessor is nominal, the lessor may be viewed as having transferred full ownership of the property for the rental fee. If the price under a purchase option is more than nominal but low in comparison to fair market value, the lessor may be viewed as having transferred full ownership because of the likelihood that the lessee will exercise the bargain purchase option.[6] Further, if the nominal lessor of property has a contractual right to require the nominal lessee to purchase the property (a "put"), the transaction could be denied lease treatment because a put eliminates the risk borne by owners of property that there will be no market for the property at the end of the lease term.

Terminal rental adjustment clauses

Lease agreements in the motor vehicle industry often contain a terminal rental adjustment clause. A terminal rental adjustment clause permits (or requires) an upward or downward adjustment of rent to make up for any difference between the projected value of a vehicle and the actual value upon lease termination.

Effect of TEFRA provision

The Internal Revenue Service has taken (and continues to take) the position that the presence of a terminal rental adjustment clause in a motor vehicle lease would cause the transaction to be treated as a conditional sale for tax purposes. However, section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) prevents the Internal Revenue Service from retroactively denying lease treatment for certain motor vehicle leases, including leases of trailers, by reason of the fact that those leases contain terminal rental adjustment clauses.

Section 210 of TEFRA does not address the legal effect of terminal rental adjustment clauses, nor does it prevent the issuance of regulations addressing the legal effect of these clauses on a prospective basis. The TEFRA provision applies only to operating leases in which the lessee uses the property for business, as opposed to personal, purposes. A lease is an operating lease if the lessor acquires the property with cash or recourse indebtedness. Thus, the provision does not apply to leveraged leases financed with nonrecourse debt.

On November 23, 1982, after the enactment of TEFRA, the Internal Revenue Service issued proposed regulations, which would apply on a prospective basis, that address the legal effect of a terminal rental adjustment clause. Under the proposed regulations, the presence of a terminal rental adjustment clause would indicate that a motor vehicle agreement is not a lease.

Decision in "Swift Dodge"

Prior to the enactment of TEFRA, the U.S. Tax Court addressed the legal effect of terminal rental adjustment clauses in motor vehicle leases in the *Swift Dodge* case.[7] In that case, an automobile dealership, which operated a separate leasing business, acquired most of its cars for lease by borrowing amounts from banks on a

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[6] *See M&W Gear Co.* v. *Comm'r*, 446 F.2d 841 (7th Cir. 1971).
[7] *Swift Dodge* v. *Comm'r*, 76 T.C. 547 (1981), *rev'd*, 692 F.2d 651 (9th Cir. 1982).

recourse basis. The Tax Court held that these nonleveraged transactions were leases and not conditional sales.

However, after the enactment of TEFRA, the U.S. Court of Appeals for the Ninth Circuit reversed the Tax Court decision, holding that a lease containing a terminal rental adjustment clause was, in substance, a conditional sale to the lessee.[8] The Court of Appeals concluded that, because the lessee bears the risk of loss and risk of fluctuation in value, the only significant risk borne by the lessor is the risk of default by the lessee, a risk assumed by any holder of a security interest in a conditional sale.

Explanation of the Bill

The bill would provide that the presence of a terminal rental adjustment clause in a motor vehicle operating agreement is not to be taken into account in determining whether the agreement is a lease.

The bill would apply to operating leases in which the lessee uses the property for business or personal purposes. However, the bill would not apply to leveraged leases financed with nonrecourse debt.

Effective Date

The amendment made by the bill would apply to motor vehicle operating agreements entered into before or after the enactment of the bill.

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[8] 692 F.2d 651 (9th Cir. 1982), *rev'g* 76 T.C. 547 (1981). The Ninth Circuit decision was based on general principles (described above) that require a lessor to retain meaningful benefits and burdens of ownership; the decision did not include a discussion of the implications of the enactment of section 210 of TEFRA. Under present law, there is an issue as to whether taxpayers resident in the Ninth Circuit are bound by this decision.

3. H.R. 2568—Messrs. Shannon, Frenzel, Matsui, Jenkins, Thomas (Calif.), and Rangel, and others

Extend Exclusion for Certain Educational Assistance Programs

Present Law

General rule

Under present law, amounts paid or expenses incurred by an employer for educational assistance provided to an employee are excluded from the employee's gross income if paid or incurred pursuant to a written plan that meets certain requirements and is for the exclusive benefit of the employees (Code sec. 127). The exclusion applies whether or not the education paid for, or furnished by, the employer is related to the employee's job.

Excludable benefits

Under this provision, an employee may exclude from income the value of educational assistance provided by the employer to the employee. Excludable amounts include tuition, fees, and similar expenses, as well as the cost of books, supplies, and equipment paid for, or provided by, the employer. (The exclusion is not available for the cost of tools or supplies provided by the employer if the employee may retain such tools or supplies after completion of the course of instruction.) However, meals, lodging, or transportation may not be excluded under this provision. The exclusion does not apply to educational assistance furnished for courses involving sports, games, or hobbies, unless the education provided involves the business of the employer.

For a program to qualify under this provision, the employee must not be able to choose taxable benefits in lieu of educational assistance benefits. In administering this rule, the business practices of an employer, as well as the written program, are to be taken into account. A qualified educational assistance program need not be funded or approved in advance by the Internal Revenue Service.

The employee may not claim a deduction (e.g., a business expense deduction) or a credit with respect to any amount that is excluded from income under this provision.

Nondiscrimination requirements

For the exclusion to be available, the educational assistance program also must meet certain requirements with respect to nondiscrimination in eligibility.

The program must benefit employees who qualify under a classification set up by the employer and found by the Internal Revenue Service 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 representatives and the employer or employers offering the program.

A program is not considered discriminatory merely because it is utilized to a greater degree by one class of employees rather 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.

The exclusion does not apply if the share of benefits received by certain employees under the program exceeds a specified level. Specifically, the benefits are not excludable if more than five percent of the benefits are paid to shareholders or owners (or their spouses or dependents, who are employees), each of whom (on any day of the year) owns more than five percent of the stock or of the capital or profits interest in the employer.[9]

Reasonable notification of the availability and terms of the program must be provided to eligible employees.

Treatment of self-employed individuals

An individual who qualifies as an employee within the definition of section 401(c)(1) also is an employee for purposes of these provisions. Thus, in general, the term employee includes self-employed individuals who have earned income for the taxable year, or any prior taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for the taxable year.

An individual who owns the entire interest in an unincorporated trade or business is treated as his or her employer. A partnership is considered the employer of each partner who is also an employee of the partnership.

Payroll tax treatment

Amounts excluded from income as educational assistance are not treated as wages subject to social security (FICA) or unemployment insurance (FUTA) taxes.

Expiration date

The exclusion (Code sec. 127) is to expire for taxable years beginning after December 31, 1983.

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[9] For determining stock ownership in corporations, this provision uses the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). Ownership interests in unincorporated trades or businesses are to be determined, under regulations, on the basis of similar principles.

Explanation of the Bill

The bill would make permanent the section 127 exclusion for certain educational assistance programs.

Effective Date

The bill would be effective on the date of enactment.

4. H.R. 3030—Mr. Schulze

Exclusion for Certain Unemployment Compensation Paid in 1979

Present Law

Prior to the Revenue Act of 1978, unemployment compensation paid under most government programs was excludable from gross income under a series of Internal Revenue Service rulings dating from 1938.[10] Section 112 of the Revenue Act of 1978 made includible a portion of unemployment compensation benefits paid pursuant to government programs to taxpayers with other substantial income during the year (Code sec. 85).

The amount of unemployment compensation included in adjusted gross income pursuant to the 1978 legislation was 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 Code section 105(d) (now repealed), over (2) the taxpayer's base amount. The Economic Recovery Tax Act of 1981 (sec. 103(c)(1)) modified the includible amount by adding to the items in (1) above the amount allowed under the deduction for two-earner married couples. Any social security benefits otherwise included in adjusted gross income under the Social Security Amendments of 1983 are not included in adjusted gross income for purposes of determining taxable unemployment compensation.[11]

The base amount in the 1978 legislation was $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. The Tax Equity and Fiscal Responsibility Act of 1982 (sec. 611) reduced the base amount for a married individual filing a joint return to $18,000, and for all other individuals (except a married individual filing a separate return) to $12,000.

The Revenue Act of 1978 provides that the unemployment compensation taxation provisions apply to payments of unemployment compensation made after 1978, in taxable years ending after 1978.

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[10] See 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 Unemployment Compensation Act of 1971); Rev. Rul. 76-63, 1976-1 C.B. 14 (unemployment compensation benefits 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).

[11] Social Security Amendments of 1983 (the Amendments), sec. 121(f)(1). The Amendments also repeal former Code sec. 105(d) and delete the reference to Code sec. 105(d) disability income in Code sec. 85 (Amendments, secs. 122(b) and 122(c)(2)).

Thus, benefits paid after 1978 may be subject to income tax even if attributable to periods of unemployment before 1978.

Explanation of the Bill

The bill would amend the Revenue Act of 1978 to provide that the provisions of that Act making includible in income certain amounts of unemployment compensation would not apply to certain unemployment compensation which is payable by reason of a 1973 work stoppage, but which was not paid until 1979. The unemployment compensation benefits that would not be taken into account in determining the taxable amount of unemployment compensation are those benefits (1) paid by reason of a work stoppage which began on March 19, 1973, and ended before July 19, 1973, and (2) paid in 1979 after the employer's appeal to the U.S. Supreme Court was dismissed on April 2, 1979, and its petition for rehearing denied on May 21, 1979.

The bill would permit taxpayers who would be entitled as a result of these provisions to a credit of any overpayment or refund, but for the operation of another law or rule of law (including res judicata), nevertheless to obtain the credit or refund by filing a claim for it before the close of the one-year period beginning on the date of enactment.

The intended beneficiaries of the bill are understood to be the individuals represented or formerly represented in collective bargaining by Local (8)-901 of the Oil, Chemical, and Atomic Workers International Union, located in Marcus Hook, Pennsylvania, who were paid unemployment compensation in 1979 by reason of the 1973 work stoppage described above.

Effective Date

The bill would be effective on enactment.

5. H.R. 3529—Mrs. Kennelly and Mr. Heftel

Modify the Tax Treatment of Regulated Investment Companies

Present Law

General rules

In general.—Under present law, a regulated investment company (RIC) is treated, in essence, as a conduit for tax purposes. If a corporation qualifies as a RIC, it is allowed a deduction for dividends paid to its shareholders. In order for a corporation to be a RIC, it must meet several requirements.

First, a RIC must be a domestic corporation which (1) at all times during the taxable year is registered under the Investment Company Act of 1940, as amended, either as a management company or as a unit investment trust, or (2) is a common trust fund that meets certain requirements.[12]

Second, the corporation must elect RIC status for the taxable year (or must have made such an election for a previous taxable year).

Third, the corporation must not be a personal holding company for the taxable year.

Fourth, the corporation must meet certain gross income and distribution requirements. In general, at least 90 percent of the corporation's gross income must be derived from dividends, interest, certain payments with respect to securities loans, and gains from the sale or other disposition of stock or securities. In addition, less than 30 percent of its gross income can be derived from the sale or other disposition of stock or securities sold for less than three months and, at the close of any quarter, at least 50 percent of its total assets must be represented by cash, cash items, government securities, government securities of other RICs, and certain other securities. Not more than 25 percent of the value of the total assets of the corporation can be invested in securities (other than government securities or securities of other RICs) of any one issuer, or of two or more issuers controlled by the taxpayer and determined to be engaged in the same, similar or a related trade or business.

Fifth, a RIC must distribute at least 90 percent of its investment company taxable income for the taxable year (determined, in general, without regard to the dividends paid deduction), and 90 percent of the amount of its tax exempt interest income over the deductions allocable to such exemption (and disallowed as deductions for that reason).

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[12] These requirements are that the corporation be a common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 from the definition of "investment company" and not included in the definition of common trust fund by Code section 584(a).

As indicated above, if a corporation qualifies as a RIC, it is allowed a deduction for distributions paid to its shareholders. The RIC shareholder is taxed on the amount of dividends received or deemed received. In addition, special rules apply with respect to capital gains income.

If any of the requirements for RIC status are not met for the taxable year, then the RIC is taxed as any regular corporation and is not entitled to the special RIC deduction for dividends paid.

Personal holding company.—Personal holding companies are subject to a special 50 percent tax on their undistributed personal holding company income. In general, a personal holding company is any corporation, other than certain types of corporations,[13] at least 60 percent of the adjusted ordinary gross income of which is dividends, interest, rents, royalties, or other types of passive income. In addition, at any time during the last half of the taxable year, 50 percent or more of the value of the corporation's outstanding stock must be owned (directly or indirectly) by or for not more than five individuals.[14]

Accounting for short-term government obligations

In the case of any short-term obligation of the United States, a State, or any possession of the United States, of any political subdivision of the foregoing, or of the District of Columbia issued at a discount and redeemable at maturity without interest, the amount of the original discount sale price is deemed to accrue at the earlier of the date the obligation is paid at maturity, or the date the obligation is sold or otherwise disposed of. For this purpose, an obligation is a short-term obligation if it has a fixed maturity date not exceeding one year from the date of issue. Thus, with respect to such obligations, accrual-basis taxpayers are not taxable on the discount until the obligation matures.

Clarification of prior statutes

The Highway Revenue Act of 1982 revised Code section 103(m) to clarify that interest on certain obligations is tax-exempt under section 103 and that, therefore, the shareholders of RICs holding such obligations qualify for tax-free treatment on the distributions of the interest on such obligations. Public Law 97-473 also revised old section 103(m) to provide cross references. Because the Highway Act was signed prior to Public Law 97-473, a question arises as to whether the provision relating to Code section 103(m) contained in the Highway Act was repealed by the later-signed law.

Explanation of the Bill

Closely held RICs

Under the bill, the limitation in the definition of regulated investment companies (RICs) which disallows RIC status to any cor-

[13] The corporations excluded from the definition of personal holding company include tax-exempt corporations, banks, savings and loans, life insurance companies, certain lending or finance companies, certain foreign held corporations, and small business investment companies.

[14] For this purpose, a trust created or organized in the United States and forming part of a qualified stock bonus, pension, or profit sharing plan and certain private foundations are included in the definition of individual.

poration that is also a personal holding company would be repealed. Therefore, a RIC could also be a personal holding company (that is, a RIC could be held by five or fewer individuals). However, in the case of any RIC which was closely held, any undistributed investment company taxable income of the RIC for that taxable year would be taxed using the highest rate of corporate tax specified in the Code. This tax would be in addition to any personal holding company tax that also applied.[15]

Further, a corporation which is a personal holding company would not be taxable as a RIC unless, in addition to the other requirements under the Code, either (1) the investment company was subject to the RIC provisions of the Code for all taxable years ending on or after June 30, 1983, or (2) the investment company had no earnings and profits accumulated in any taxable year in which the RIC provisions of the Code were not applicable to it.

Accounting for short-term government obligations

The bill provides that the original market discount accruing with respect to any short-term government obligation would be taxable to the RIC as it accrues, if the company so elects in a manner prescribed by the Internal Revenue Service. This provision would permit RICs to conform the income tax accounting rules for short-term government obligations with the book accounting methods required by the Securities and Exchange Commission.

Clarification of prior statutes

Finally, the bill clarifies that Public Law 97-473 did not repeal the exempt interest provision added by the Highway Revenue Act of 1982.

Effective Date

The definitional provisions of the bill would be effective for taxable years beginning after 1982. The amendment with respect to the accrual of short-term government discount income would be effective retroactively with respect to taxable years beginning after 1978.

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[15] The personal holding company tax would apply in most cases other than RICs also qualifying as small business investment companies, and certain other exceptions.

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