[COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON AUGUST 28, 1978

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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I. INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on August 28, 1978, by the Subcommittee on Taxation and Debt Management of the Committee on Finance. The bills include 3 bills which have passed the House of Representatives. One of these bills, H.R. 810, was previously listed for hearing on June 19, 1978.

The pamphlet first briefly summarizes the bills, in the order in which the bills were listed in the press release announcing the hearings. This is followed by a discussion of each bill, setting forth present law, the issue involved, an explanation of what the bill would do, the bill's effective date, the revenue effect of the bill, any prior Congressional consideration of the bill, and the position of the Treasury Department with respect to the bill. The sponsor or sponsors of each bill are listed in the table of contents.

II. SUMMARY

1. H.R. 810

Treatment of Payment or Reimbursement by Private Foundations for Expenses of Foreign Travel by Government Officials

Present law, in effect, prohibits any "self-dealing" between private foundations and "disqualified persons." Under these rules, any payment or reimbursement by a private foundation of expenses of government officials generally is classified as an act of self-dealing. However, a limited exception in existing law permits a private foundation to pay or reimburse certain expenses of government officials for travel solely within the United States.

The bill (H.R. 810) broadens this existing exception to permit a private foundation (other than a foundation supported by any one business enterprise, trade association, or labor organization) to pay or reimburse government officials for certain expenses of foreign travel under similar types of limitations as apply under current law in the case of expenses for domestic travel.

2. H.R. 4030

Excess Business Holdings of a Private Foundation in a Public Utility

This bill would permit a private foundation and its "disqualified persons" together to hold in excess of 50 percent of the stock of a public utility for an additional 10-year period, if certain requirements are met.

3. H.R. 5099

Relief of Brian Hall and Vera W. Hall

The bill would extend private relief to Mr. and Mrs. Brian Hall so that they would qualify for nonrecognition of the gain from sale of their principal residence.

4. S. 2771

Exemption for Income Received by Certain Tax-Exempt Organizations From Bingo and Similar Games

Under present law, most organizations which are generally exempt from Federal income taxes are subject to tax on their unrelated business taxable income.

S. 2771 would provide that most tax-exempt organizations (under sec. 501(a)) would not be subject to tax on income from bingo and similar games that are conducted in accordance with State and local law and not in competition with profit-making businesses, even though such games are regularly carried on with paid labor.

5. S. 1611 and S. 3049

Reserves for Product Liability Losses

Under present law, a deduction is not generally allowed in the current year for amounts set aside in a reserve to pay estimated future product liability claims. Instead, the taxpayer is allowed a deduction for the product liability claim in the year that it is determined he is liable to pay it.

The bills would allow a deduction in the current year for amounts set aside to meet future product liability claims. The amount of deduction would be subject to certain limitations, and rules are provided to help ensure that the funds set aside are used solely to satisfy product liability claims.

6. S. 3176

Contributions in Aid of Construction to Gas and Electric Utilities

The bill would treat certain contributions to regulated public gas and electric utilities in aid of construction as contributions to capital by nonshareholders and not as taxable income to the utility.

7. S. 3345

Deficiency Dividends for Regulated Investment Companies Which Are Small Business Investment Companies

Under present law, a mutual fund qualifying for conduit treatment must distribute 90 percent of its taxable income within its taxable year or, with certain limitations, within the 12-month period after the taxable year. No deficiency dividend procedure is provided with respect to distributions made after this period. The bill would provide a deficiency dividend procedure for mutual funds that are also small business investment companies.

8. S. 3441

"The Independent Local Newspaper Act of 1978"

The bill would allow independent local newspapers to establish tax-exempt trust funds in order to pay the estate taxes of the owners of the paper. Contributions to the trust by the paper would generally be deductible in computing income tax, and interests in the trust would be exempt from the estate tax. In addition, the bill would provide an extended payment period for estate taxes attributable to interests in independent local newspapers.

III. DESCRIPTION OF BILLS

1. H.R. 810

Treatment of Payment or Reimbursement by Private Foundations for Expenses of Foreign Travel by Government Officials

Present law

The Tax Reform Act of 1969 added a provision to the Code (sec. 4941) which in effect prohibits "self-dealing" acts between private foundations and certain designated classes of persons (referred to as "disqualified persons") by imposing a graduated series of excise taxes on the self-dealer (and also on any foundation manager who willfully and knowingly engages in self-dealing acts). Under this provision, the payment or reimbursement by a private foundation of expenses of a government official generally is classified as an act of self-dealing (sec. 4941(d)(1)(F)).

A limited exception to this provision permits a private foundation to pay or reimburse certain expenses of government officials for travel solely within the United States (sec. 4941(d)(2)(G)(vii)). Under this exception, it is not an act of self-dealing for a private foundation to pay or reimburse a government official for actual transportation expenses, plus an amount for other traveling expenses not to exceed 1¼ times the maximum *per diem* allowed for like travel by Federal employees. However, no such private foundation payment or reimbursement to government officials is permitted for travel to or from a point outside the United States.

Issue

The issue is whether private foundations should be permitted to pay or reimburse government officials for expenses for foreign travel and, if so, under what circumstances.

Explanation of the bill

The bill provides that a private foundation does not engage in an act of self-dealing in paying or reimbursing certain expenses of government officials paid or incurred for travel between a point in the United States and a point outside the United States. The maximum amount which can be paid or reimbursed by a private foundation for any one trip by a government official is the sum of (1) the lesser of the actual cost of the transportation involved or $2,500, plus (2) an amount for all other traveling expenses not in excess of 1¼ times the maximum amount payable under section 5702(a) of title 5, United States Code (relating to like travel by a U.S. Government employee) for a maximum of 4 days.[1]

The exception added by this bill is not available to a private foundation if more than one-half of the foundation's support (as defined in sec. 509(d)) is normally derived from any one business enterprise, any one trade association, or any one labor organization, whether such support takes the form of interest, dividends, other income, grants, or contributions.

Effective date

The bill would apply with respect to travel beginning after the date of enactment.

Revenue effect

It is estimated that this bill would not have any direct revenue effect.

Prior Congressional action

An identical bill (H.R. 2984, 94th Cong.) was passed by the House of Representatives by voice vote on May 18, 1976, but was not acted upon by the Senate Finance Committee or considered by the Senate.

Treasury position

The Treasury Department recommends that the bill should be amended to limit the permitted amount of reimbursable transportation expenses to the cost of the lowest coach or economy air fare charged by a commercial airline.

The recommended change would make the reimbursable amounts under the bill consistent with the limitation on deductions for attending foreign conventions under the Administration's 1978 tax program. The Treasury Department would not oppose the bill if this change were made.

2. H.R. 4030

Excess Business Holdings of a Private Foundation in a Public Utility

Present law

The Tax Reform Act of 1969 imposed an excise tax upon the excess business holdings of a private foundation (sec. 4943 of the Code). Generally, under the excess business holdings provisions, the combined ownership of a business by a private foundation and all disqualified persons cannot exceed 20 percent of the voting stock of the business (35 percent if other persons have effective control of the business).

The 1969 Act provided that, if a private foundation and disqualified persons together had holdings on May 26, 1969, in excess of the permitted amounts under the general rules, then those holdings could be retained if they consisted of not more than 50 percent of the business.

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[1] Under 5 U.S.C. 5702(a), in the case of travel outside the continental United States, the President or his designee has the authority to establish the maximum *per diem* allowance for the locality where the travel is performed. Currently, for example, 1¼ times the daily amount so established for travel expenses in London is $102.50, for travel in Paris, $100.00, and for travel in Tokyo, $110.00.

If the combined holdings exceeded 50 percent of the business on that date, then over a transitional period the combined holdings would have to be reduced to 50 percent (ultimately to 35 percent if the disqualified persons hold, in the aggregate, no more than 2 percent of the business; if they hold more than 2 percent, then the combined holdings may continue to be as much as 50 percent, of which the foundation itself may hold no more than 25 percent).

In the case of a private foundation owning more than 50 percent (but no more than 75 percent) of a business, the private foundation is given 10 years (ending on May 26, 1979) within which to reduce its holdings to 50 percent (or lower, as explained above). In the case of a private foundation owning more than 75 percent (but not more than 95 percent) of a business, the private foundation is given 15 years (ending on May 26, 1984) within which to reduce its ownership to 50 percent (or lower, as explained above). In the case of a private foundation owning more than 95 percent of a business, the private foundation is given 20 years (ending on May 26, 1989) within which to reduce its ownership to 50 percent (or lower, as explained above).

Issue

The issue is whether a private foundation and its disqualified persons together should be permitted to continue to hold more than a 50-percent interest in a public utility until May 26, 1989, where the public utility is regulated, is relatively small, is not directly managed by disqualified persons, distributes to its shareholders at least 40 percent of its aftertax earnings, and meets certain other requirements.

Explanation of the bill

The bill would provide an additional 10 years within which certain private foundations must dispose of excess business holdings in certain public utilities. In effect, the bill provides the normal 20-year transitional rule applicable to private foundations holding more than 95 percent of a business to holdings by certain private foundations in certain public utilities to which the normal 10-year or 15-year transitional rules would normally apply.

In order to qualify for the special exception for public utility stock, the following tests would have to met:

(1) the private foundation must have held on May 26, 1969, at least 50 percent of the voting stock of the public utility (for this purpose, stock held in a trust or decedent's estate created before May 27, 1969, is deemed held by the private foundation if the foundation is the primary or remainder beneficiary of the trust or estate);

(2) all of the public utility stock owned by the private foundation must have been acquired by gift, devise, or bequest;

(3) no officer, director, or trustee of the public utility can be a person who contributed stock to the private foundation or a member of the family of any person who gave, devised, or bequeathed any public utility stock to the foundation;

(4) the utility must have been a public utility on May 26, 1969;

(5) the utility's taxable income for the first taxable year ending after May 26, 1969, must have been less than $1,000,000;

(6) the utility must have distributed to its shareholders, in each of any 3 of the 5 years preceding the year of enactment and each year ending after the date of enactment, at least 40 percent of its net income (determined after Federal, State, and local taxes for that year) ; and

(7) the private foundation does not purchase any interest in the public utility after the date of enactment.

This bill is intended to apply to the holdings of the Hauss-Helms Foundation in the Telephone Service Company of Wapakoneta, Ohio.

Effective date

The bill would apply to taxable years ending after the date of enactment.

Revenue effect

It is estimated that this bill will not have any direct revenue effect.

Treasury position

The Treasury Department opposes this bill. The Treasury Department is opposed to creating special exceptions to the excess business holdings provisions on an *ad hoc* basis. Regardless of the nature of the business controlled by the foundation and its donor or donors, the mere existence of foundation control inevitably tends to direct the foundation's efforts to operating the business more profitably and thus to divert attention from the charitable purposes of the foundation.

3. H.R. 5099

Relief of Brian Hall and Vera W. Hall

Present law

Under present law, the entire amount of gain or loss realized on the sale or exchange of property generally is recognized. However, under a so-called "rollover" provision of the Code (sec. 1034), 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 (as defined in sec. 1034(b)) 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. (If the taxpayer constructs the new residence and construction begins within 18 months after the sale of the old residence, the taxpayer has up to 24 months, rather than 18, after the sale of the old residence to construct and use the new residence as his principal residence.) The basis of the new residence then is reduced by the amount of gain not recognized on the sale of the old residence.

The 18- or 24-month periods are extended up to 4 years during periods when the taxpayer serves on extended active duty with the Armed Forces of the United States, but there are no other statutory provisions for extension of the time limits.

A similar "rollover" rule applies to property sold under threat or imminence of condemnation or otherwise converted involuntarily (sec. 1033). Generally, if a taxpayer acquires a new principal residence after the threat or imminence of condemnation of his old residence occurs, he will recognize gain on the subsequent sale of his old residence only to the extent that the proceeds of the sale exceed the cost of his new residence. If the old residence is sold first, the taxpayer has up to 2 years after the close of the first taxable year in which he realizes any part of the gain from the sale to purchase a new residence and avoid recognition of gain. Moreover, the Internal Revenue Service is authorized to extend this 2-year period for reasonable cause.

On October 24, 1975, Mr. and Mrs. Hall purchased a new residence located in Laguna Beach, California. However, they had difficulty selling their previous residence, located in Glendale, California. The House Judiciary Committee stated in its report on the bill that this delay was due to the disruption to the area caused by the construction of the Glendale Freeway, located less than 200 yards from the Halls' old residence. The Halls finally sold their Glendale property on June 15, 1977. However, the statutory 18-month period for the nonrecognition of gain on the sale of the old residence had expired on April 24, 1977. The 24-month period for rollover of the gain, which takes delays in construction of a new residence into account, was unavailable to the Halls. Because their old residence was not sold under threat or imminence of condemnation, they could not take advantage of the different rollover timing rules of section 1033.

Issue

The issue is whether the 18-month period (for nonrecognition of gain under sec. 1034) between the purchase of a taxpayer's new residence and the sale of his old residence should be extended for Mr. and Mrs. Hall.

Explanation of the bill

The bill provides that the Halls are to be deemed to have sold their residence in Glendale, California, within 18 months of the date of the purchase of their new residence at Laguna Beach, California, if they have in fact sold the residence in Glendale, California, not later than 6 months after the date of the enactment of the bill. Since the Glendale, California, residence was sold on June 15, 1977, the 18-month requirement of section 1034 would be met.

Effective date

The bill would take effect on the date of its enactment.

Revenue effect

It is estimated that the bill will have a negligible revenue effect.

Treasury position

The Treasury Department opposes this bill.

4. S. 2771

Exemption for Income Received by Certain Tax-Exempt Organizations From Bingo and Similar Games

Present law

Under present law, most organizations which are generally treated as tax-exempt under the Internal Revenue Code are nonetheless subject to tax on their unrelated business taxable income (sec. 511). Thus, unless a specific exception applies, an organization which is tax-exempt (under sec. 501(a))[1] is subject to tax with respect to income derived from any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds) to the exercise or performance of its exempt function.

Under some State laws, nonprofit organizations are allowed to conduct bingo games or other similar types of games to raise funds for their exempt purposes. Often State laws limit the conduct of these types of games to nonprofit organizations.

Two recent cases have held that tax-exempt organizations are subject to unrelated business income tax on the proceeds of bingo games regularly carried on by the organizations with paid labor even though the organizations were not in competition with for-profit businesses.[2]

Issue

The primary issue is whether tax-exempt organizations should be subject to taxation on income from bingo and similar games that are conducted in accordance with State and local law and not in competition with profit-making businesses even though such games are regularly carried on with paid labor.

Explanation of the bill

This bill would exempt from taxation the proceeds of bingo and similar types of games in situations where State or local law permits such activities to be carried on by nonprofit organizations. This exemption from taxation would apply even though the activity is regularly carried on and is carried on with paid workers. However, to qualify for this exemption from the unrelated business income tax, the activity must not ordinarily be conducted on a commercial basis in the State in which the organization operates, and the conduct of the activity must not violate State or local law.

This bill would apply to games of the type in which usually the wagers are placed, the winners are determined, and the prizes are distributed in the presence of all persons placing wagers in the game. Thus, this bill would generally apply to bingo games, keno games, card games, dice games, and games involving wheels of chance, such as roulette wheels. (The statutory definition follows one of the exclusions from the term "lottery" under the wagering tax (sec. 4421(2)(A) of the Code).)

Effective date

This bill would apply to taxable years beginning after December 31, 1969.

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[1] In this pamphlet, references to "exempt organizations" do not include social clubs (sec. 501(c)(7)) and employees' beneficiary association (sec. 501(c)(9)), which may be taxable on investment income of all types as well as unrelated business income. The term "exempt organizations," as used also does not include political organizations (as described in sec. 527) and homeowners' associations (as described in sec. 528).

[2] *Clarence LaBelle Post No. 217* v. *United States*, —— F. 2d —— (8th Cir. 1978), 78-1 USTC ¶9496; *Smith-Dodd Businessman's Assn.*, 65 T.C. 620 (1975). In the *Smith-Dodd* case, a specific exemption for trades or businesses in which substantially all the work is performed without compensation (sec. 513(a)(1)) was held to be inapplicable because the organizations paid the workers $2 per hour and these sums could not be specifically correlated with the workers expenses. (The court indicated that expense reimbursement of workers might not violate the "without compensation" requirement.)

Revenue effect

It is estimated that this bill will reduce budget receipts by $15 to $20 million annually. This figure does not take into account the retroactive effective date which could increase the 1979 fiscal year revenue loss several times over this amount.

Treasury position

The Treasury Department would not oppose this bill if it were (1) limited to bingo and excluded other wagering games; (2) limited to areas where the conduct of bingo by exempt organizations is sanctioned by applicable State or local law and, under such law, bingo may not be conducted by profit-making enterprises; and (3) revised to make clear that, notwithstanding the exemption of such income from the unrelated business income tax, an organization still might jeopardize its exempt status if the extent of its bingo activities became excessive by comparison with its exempt activities. The Treasury Department also believes that it is inappropriate to extend this exemption to all organizations described in section 501(c).

5. S. 1611 and S. 3049

Reserve for Product Liability Losses

Present law

Under present law, taxpayers generally are not allowed to deduct estimated future expenses even though they may be related to current income. Specific exceptions to this rule presently provided in the Code include the deduction for bad debts on the reserve method (section 166(c)), accrual of amounts due to employees for vacation pay (section 463), and reserves of insurance companies to meet certain obligations to policyholders (subchapter L of the Code).

The general rule provides that deductions for expenses and losses may be claimed only when all events have occurred that fix the fact of the liability and the amount can be determined with reasonable accuracy (Treas. Reg. § 1.461-1(a)(2)). This is known as the "all events test." Under this test, deductions are not allowed for reserves for anticipated product liability losses because the losses have not occurred as of the close of the taxable year.[1] On the other hand, the losses are deductible in the year liability is fixed (either by settlement or judicial decree).

Under present law, taxpayers generally may claim a deduction for amounts paid to an insurance company to insure against anticipated losses, such as product liability losses. If a premium covers a period of more than 12 months, it is usually required to be prorated and deducted over the period of coverage. Losses covered by insurance are not deductible by a taxpayer, but losses in excess of insured amounts generally are deductible when the "all events test" has been met.

[1] For a short period in 1954 and 1955, the Code provided a general rule (section 462) that allowed taxpayers to claim a tax deduction for certain anticipated expenses and losses related to current income. Among the items specifically covered by that provision were product guarantees and certain liabilities for self-insured injury and damage claims. The provision, along with its companion rule for income (section 452), was intended to conform tax accounting and financial accounting to a much greater extent than had ever been done before. Soon after enactment of the 1954 Code, it became apparent that the revenue loss from the two provisions would be much greater than originally anticipated. The two provisions were repealed in 1955, retroactive to their effective date.

Some taxpayers have established wholly owned subsidiary corporations whose business it is to insure against certain losses of the parent corporation and other members of the controlled group. These kinds of insurance companies are referred to as "captive insurance companies." The Service has taken the position (Revenue Ruling 77-316, I.R.B. 1977-35, 7) that premium payments to captives generally are not deductible because there has been no shifting of risk outside the controlled group. The Service argues that the premium payments amount to nothing more than a funding of a reserve that is normally not deductible.

Issues

Should a deduction be allowed for amounts set aside in a reserve to fund product liability losses? If a deduction is to be allowed, other issues that arise are: (1) Should product liability include liability for professional services, such as medical or lawyer malpractice? (2) Should the reserve be required to be placed in a trust (tax-exempt or otherwise) with penalties for premature withdrawals or improper use of funds? (3) Should limits be established on the amount that could be set aside and deducted in any single year and in the aggregate.

Explanation of the bills

S. 1611.—The bill would allow a deduction for limited amounts set aside in a trust fund to meet product liability losses. The product liability trust fund must be created or organized in the United States for the exclusive purpose of paying product liability losses sustained by the taxpayer. The trustee must be a bank or other person satisfactory to the Secretary of the Treasury. The earnings of the trust would be taxable, and its assets could not be commingled with other property except in a bank common trust fund.

The amount of deduction could not exceed 3 percent of the taxpayer's gross receipts for the taxable year from the activity that may give rise to the potential product liability. Further, the aggregate amount in the reserve could not exceed 15 percent of the average of the taxpayer's last 5 years' gross receipts from the activity that may give rise to the potential product liability. Product liability losses would not be deductible unless they exceeded the contributions to the account.

Improper use of account funds would cause the amount improperly used to be included in income, and, in addition, be subjected to a 50 percent penalty tax. In the case of a controlled group of taxpayers, each member of the controlled group (as specially defined in the bill) is to be treated as a separate taxpayer for purposes of determining the limitation on the deduction. The definition of product liability under the bill includes liability for personal injury or property damage arising out of the manufacture, importation, distribution, lease, sale or installation of products by the taxpayer.

S. 3049.—The bill would provide for a deduction for amounts contributed to a product liability trust and premiums paid to a captive insurer with respect to the product liability of the taxpayer. (It is not clear under the bill whether earnings retained in the trust would be taxable.) The product liability trust must be created or organized in the United States for the exclusive purpose of paying product liability losses sustained by the taxpayer. For this purpose, product liability losses include expenses incurred in the investigation, settlement and opposition of product liability claims.

The trustee of the trust must be a bank or other person satisfactory to the Secretary of the Treasury. The assets of the trust could not be commingled with other property except in a bank common trust fund. The assets of the trust may not be invested in anything other than (1) public debt securities of the United States, (2) obligations of a state or local government which are not in default as to principal or interest, and (3) time or demand deposits in a bank or an insured credit union located in the United States.

The bill establishes limitations on the amount that may be deducted in any year with respect to any taxpayer. The amount of limitation depends on whether the taxpayer has a severe product liability insurance problem. A taxpayer is considered to have a severe product liability insurance problem for a taxable year if (1) he is unable to obtain a premium quotation for product liability insurance with coverage of up to $1 million, or (2) the lowest insurance premium quotation for such coverage is more than 3 percent of the taxpayer's gross receipts for the taxable year.

In the case of a taxpayer that has a severe product liability insurance problem, the annual deduction may not exceed 5 percent of the taxpayer's gross receipts for the taxable year from activities that may give rise to potential product liability. The aggregate amount in the trust may not exceed 15 percent of the average of the taxpayer's last five years' gross receipts from activities that may give rise to the potential product liability. In no event could the annual deduction exceed $100,000.

In the case of a taxpayer who does not have a severe product liability insurance problem, the annual deduction to the product liability trust may not exceed 2 percent of the taxpayer's gross receipts for the taxable year from activities that may give rise to potential product liability. Further, the aggregate amount in the trust could not exceed 10 percent of the average of the taxpayer's last 5 years' gross receipts from the activity giving rise to the potential product liability. In no event could the annual deduction exceed $25,000.

The bill makes it clear that a deduction will be allowed for premiums paid to a United States captive insurer, but that the premiums and contributions to a product liability trust would be aggregated for purposes of applying the limitations. In the case of a controlled group of taxpayers, only the gross receipts properly attributable to each member of the controlled group would be taken into account for purposes of determining the limitation on the deduction applicable to each separate member.

Product liability losses would not be deductible unless they exceeded the contributions to the trust. Improper use of account funds would cause the amount improperly used to be included in income, and, in addition, be subjected to a 50-percent penalty tax. The definition of product liability under the bill includes liability for personal injury or property damage arising out of the manufacture, importation, distribution, lease, sale or installation of products by the taxpayer.

Amounts accumulated in a taxpayer's product liability trust or captive insurer would be treated for purposes of the accumulated earnings tax as amounts accumulated for the reasonably anticipated needs of the taxpayer.

Effective date

Both S. 1611 and S. 3049 would be effective for taxable years beginning after December 31, 1977.

Revenue effect

S. 1611.—The revenue effect of this bill on budget receipts depends significantly on the rate by which companies elect under its provisions. If approximately ten percent of the eligible companies contribute one quarter of the eligible amount initially, and maintain the balance in later years, then the reduction of budget receipts is estimated to be $1.1 billion in 1979, $0.8 billion in 1980, and $0.7 billion in 1983.

S. 3049.—It is estimated that this bill will reduce budget receipts by $145 million in fiscal 1979, $110 million in 1980, and $24 million in 1983.

Treasury position

The Treasury Department opposes permitting a current deduction for contributions to a product liability trust under arrangements that result in tax deferral. Both S. 1611 and S. 3049 involved some elements of tax deferral and are therefore objectionable.

The Treasury Department believes that an appropriate tax response to the product liability problem is a long-term (10 years) net operating loss carryback for net operating losses attributable to product liability losses, an approach that does not result in tax deferral.

6. S. 3176

Contributions in Aid of Construction of Gas and Electric Utilities

Present 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 to regulated utilities in aid of construction (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 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 property and the utility's main water or sewer lines (including the costs of meters and piping) and any amounts paid as service charges for stopping or starting service. In addition, the Act provided that a water or sewerage utility which received a nontaxable contribution in aid of construction was to receive no depreciation deductions or investment credit on property acquisitions attributable to the contribution.

The Act did not affect the treatment of contributions to utilities other than water and sewerage utilities.

Issue

The issue is whether contributions in aid of construction to regulated public gas and electric utilities should be treated as contributions to the capital of those utilities by nonshareholders or as taxable income to the utilities.

Explanation of the bill

The bill provides that contributions in aid of construction, received by gas and electric utilities, would be treated as contributions to capital by nonshareholders and not as taxable income to the utility. The bill would extend to these utilities the provisions applicable to water and sewerage utilities. Accordingly, similar taxable treatment would apply to customer connection fees. Also depreciation and investment tax credits would not be allowable for property acquired with the nontaxable contributions.

Effective date

The bill would apply to contributions made after January 31, 1976.

Revenue effect

If all the contributions in aid of construction 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 budget receipts, however. If the electric and gas utilities rely on past treatment and file tax returns as if Revenue Ruling 75–557 applied only to water and sewage companies, 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 limited to water and sewage utilities and does not apply to gas and electric utilities, and if court decisions would be in favor of the utilities, 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 historic tax treatment of contributions in aid of construction of regulated public utilities.

Prior Congressional action

The provision relating to contributions in aid of construction for regulated public water and sewage utilities was added to the 1976 Act by the Senate Finance Committee. The Committee provision did not apply to gas and electric utilities. During the consideration of the 1976 Act on the Senate floor, an amendment was offered to include gas and electric utilities but the amendment was not adopted.

Treasury position

The Treasury Department opposes the bill.

7. S. 3345

Deficiency Dividends for Regulated Investment Companies Which Are Small Business Investment Companies

Present 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 the investors each year is taxed to them without being subjected to a tax at the company's 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 its distributions to the investors.

A small business investment company is a company formed under the Small Business Investment Act of 1958 to furnish equity capital and long-term credit for small business concerns. These investment companies may qualify to be treated as regulated investment companies.

In order to qualify for conduit treatment, a company, including a small business investment 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 investment-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). Unlike the treatment of real estate investment trusts, no deficiency dividend procedure is provided for a regulated investment company 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 cause the company to fail to meet the distribution requirement.

Issue

The issue is whether a regulated investment company which is also a small business investment company should be permitted to pay qualifying dividends after the expiration of the regular period for the payment of qualifying dividends.

Explanation of the bill

The bill would provide a deficiency dividend procedure for regulated investment companies that are also small business investment companies. The procedure would be available only for a small business investment company which is licensed under the Small Business Investment Act of 1958 and which qualifies and elects to be taxed as a regulated investment company.[1]

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.

The bill would benefit the Allied Investment Company of Washington, D.C. In addition, there are approximately 28 small business investment companies which have elected, or may elect, to be taxed as regulated investment companies and which might benefit from the bill.

Effective date

The bill would be effective for determinations occurring after the date of enactment.

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[1] The Federal Tax Division of the American Institute of Certified Public Accountants has recommended the adoption of a deficiency dividend procedure similar to that provided for real estate investment trusts for all regulated investment companies rather than just those companies which are also small business investment companies. Federal Tax Division of the American Institute of Certified Public Accountants, *Recommended Tax Law Changes* 69 (1977).

Revenue effect

It is estimated that enactment of this bill would reduce budget receipts by about $200,000 in fiscal year 1979 and by less than $500,000 annually thereafter.

Treasury position

The Treasury Department supports the bill and supports extension of the deficiency dividend procedure to all regulated investment companies. However, the Treasury believes that the bill in its present form should be amended in certain technical respects. In particular, the procedure should be conformed to that provided for real estate investment trusts by the Tax Reform Act of 1976. (See secs. 1601(b)-(f) of P.L. 94-455.)

8. S. 3441

"The Independent Local Newspapers Act of 1978"

Present law

With respect to a trust established for the purpose of paying estate taxes attributable to an interest in a business (including an independent local newspaper), no provision is presently made under the Code for (1) according tax-exempt status to such a trust, (2) allowing income tax deductions for payments to the trust, or (3) excluding the corpus of the trust from estate taxes.

The Code provides extended payment provisions with respect to the estate tax attributable to interests in closely held businesses (secs. 6166 and 6166A).[1]

In addition, provision is made for capital gain treatment of certain redemptions of closely held business stock where the redemption is for the purpose of paying estate taxes (sec. 303).[2]

Issues

The main issues are (1) whether the owner of an independent local newspaper should be permitted to establish a tax-exempt trust to pay estate taxes attributable to the value of his interest in the newspaper, (2) whether the funds contributed to the trust (within prescribed limits) should be deductible by the newspaper for income tax purposes, (3) whether the value of the trust assets should be excludable from the owner's taxable estate in computing estate taxes, and (4) whether

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[1] Section 6166 provides a 15-year period for the payment of the estate tax attributable to the decedent's interests in a closely held business (including a farm). Under this provision, the executor can elect to defer principal payments for up to 5 years from the due date of the estate tax return. Thereafter, pursuant to the executor's initial election, the principal amount of the estate tax liability may be paid in from 2 to 10 installments. In order to qualify for this deferral and installment payment treatment, the value of the closely held business (or businesses) in the decedent's estate must exceed 65 percent of the value of the gross estate reduced by allowable expenses, indebtedness, and losses.

Section 6166A provides a 10-year extended payment of estate tax attributable to a closely held business where a lesser proportion of the estate is represented by its value. 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.

[2] To qualify for this treatment, the value of the stock redeemed, plus the value of the other stock of the redeeming corporation includible in the estate, must be more than 50 percent of the "adjusted gross estate." The value of the stock redeemed can be no greater than the sum of all death taxes (and interest) plus funeral and administration expenses allowable as an estate tax deduction.

a 15-year period should be provided for the payment of any estate tax attributable to the value of an interest in the newspaper to the extent the tax was not paid by the trust.

Explanation of the bill

Under the bill, an independent local newspaper could establish a tax-exempt trust to receive payments to pay the estate tax liability of the owner of the newspaper. The newspaper would be allowed an income tax deduction in an amount not to exceed 50 percent of its taxable income for amounts paid to the trust. The trust assets would be required to be invested solely in obligations of the United States. The assets of the trust could be used only to pay the Federal estate taxes of the owner of the newspaper.

The trust would be limited to holding amounts necessary to pay the potential Federal estate tax liability of the newspaper owner. In determining this limitation, the potential estate tax liability of a living individual would be considered to be 70 percent (i.e., the maximum estate tax rate) of the value of his interest in the business. Under the bill, any interest of a decedent in the trust would generally not be included in the decedent's gross estate.

If the owners of a newspaper which has established a trust for their benefit dispose of their interest in the newspaper, the amounts in the trust must be distributed and included in the owners' income and the deduction previously allowed the newspaper would be recaptured.

An "independent local newspaper" is defined as a newspaper publication which is not a member of a chain of newspapers if it has all of its publishing offices in a single city, community or metropolitan area, or, as of October 31, 1977, within one State. A "chain of newspaper publications" is defined as two or more newspaper publications under common control on October 31, 1977, and which are not published in a single city, community, or metropolitan area.

Under the bill, payment of any estate tax attributable to the value of an independent local newspaper not paid by a trust established under the provisions of this bill could be extended for a period of up to 15 years. This provision would apply where the estate does not qualify under existing extended payment provisions of present law. (See secs. 6166 and 6166A.)

Under this extended payment provision, the executor could elect to defer principal payments for up to 5 years from the due date of the estate tax return. However, interest for the first five years, payable at the rate of 4 percent, would be payable annually. Thereafter, the principal amount of the estate tax liability could be paid in from 2 to 10 annual installments. If the business ceases to qualify as an independent local newspaper, the extension would terminate.

Effective date

The provisions of the bill would apply to estates of decendents dying after October 1, 1977.

Revenue effect

It is estimated that this bill will reduce budget receipts by $10 million annually.

Treasury position

The Treasury Department opposes this bill.

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