DESCRIPTION OF BILLS

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BY THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

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1. H.R. 4155—Mr. Simon

SUMMARY

Disclosure of Mailing Addresses of Individuals Defaulting on Certain Student Loans

Present law authorizes the Secretary of the Treasury to disclose to the Commissioner of Education the mailing addresses of taxpayers who ~~have defaulted~~ on certain student loans made under the Higher Education Act of 1965 for use in locating such taxpayers and collecting the loans. However, there is no provision for the disclosure of mailing addresses of taxpayers who have defaulted on student loans made under the Migration and Refugee Assistance Act.

The bill would expand present law to allow the Secretary to disclose the mailing addresses of taxpayers who have defaulted on student loans made under the Migration and Refugee Assistance Act.

Description of Bill

Present law

Under present law, the Secretary of the Treasury may disclose to the Commissioner of Education the mailing address of any taxpayer who has defaulted on a loan made from the student loan fund established under part E of Title IV of the Higher Education Act of 1965 (Code sec. 6103(m)(4)). The addresses disclosed by the Secretary may be used only for the purpose of locating taxpayers who have defaulted on student loans in order to collect the defaulted amounts.

Any mailing addresses which have been disclosed to the Commissioner of Education may, in turn, be disclosed to any educational institution with which there is an agreement under part E of Title IV of the Higher Education Act of 1965. Officers, employees, or agents of such an institution, whose duties relate to the collection of student loans, may use the addresses for purposes of locating individuals who have defaulted on student loans.

Issue

The issue is whether present law should be expanded to permit the Secretary to disclose the mailing addresses of taxpayers who have defaulted on student loans made under the Migration and Refugee Assistance Act of 1962.

Explanation of the bill

The bill would authorize disclosure to the Commissioner of Education of the mailing address of any taxpayer who has defaulted on a loan made pursuant to section 3(a)(1) of the Migration and Refugee Assistance Act of 1962 to a student at an institution of higher education. The disclosure could be made only upon written request by the Commissioner of Education to the Secretary. Any mailing address ~~disclosed under~~ this provision could be used only for the purpose of locating the taxpayer in order to collect the loan.

Effective date

The provisions of the bill would be effective upon enactment.

Revenue effect

This bill is not expected to have any direct revenue effect.

Additional Items for Subcommittee Consideration

The Subcommittee may wish to add provisions to deal with several items raised in correspondence received from the Secretary of HEW. A technical change in existing law would be to substitute the term "Secretary of Education" for the Commissioner of Education. Also, the correspondence suggested that disclosure authority be expanded to include guarantee agencies participating in the Guaranteed Student Loan Program.

2. H.R. 4725—Mr. Rostenkowski

SUMMARY

Printing of Airline Ticket Tax Amount

The bill would repeal the present requirement to show on an airline ticket the amount paid for transportation and the Federal excise tax on air transportation for each segment of the taxable transportation. The requirement that the ticket to show the total air fare and total tax for each trip would be retained.

Description of Bill

Present law

Present law (Code sec. 7275) requires that an airline ticket show the total of (a) the amount paid for the air transportation and (b) the Federal excise tax imposed on the air transportation under Code section 4261.[1] Further, if amounts paid with respect to any segment of the air transportation are shown on the ticket, the ticket shall also show the total of the amount paid and the Federal excise tax with respect to the segments, as well as for the sum of the segments.

In addition, any advertising of taxable air transportation which states the cost of such transportation is required to state such cost as the total of (a) the amount paid for the air transportation and (b) the Federal excise tax. Where the advertising separately states the amount to be paid for the air transportation and the Federal excise tax, the advertising must show the combined total (transportation plus tax) at least as prominently as the other stated amounts, and the excise tax is to be described as "user taxes to pay for airport construction and airway safety and operations." Finally, present law provides a penalty for $100 for each violation upon conviction (as a misdemeanor)

Issue

The issue is whether air transportation tickets which show amounts paid by segments should be required to show the amounts paid and the Federal excise tax for each segment of the transporation.

Explanation of the bill

The bill would repeal the present requirement that air transportation tickets show the amount paid and the Federal excise tax for each segment of the transportation. It would retain the requirement, however, that the tickets show the total amount paid and the total amount of Federal excise tax imposed on the air transportation.

Effective date

The provisions of the bill would be effective upon date of enactment.

Revenue effect

This bill is not expected to have any direct revenue effect.

[1] The present rate is 8 percent, which is scheduled to decline to 5 percent on July 1, 1980.

3. H.R. 6039—Mr. Lederer

SUMMARY

Tax Treatment of Annuities Purchased for Employees of the Uniformed Services University of the Health Sciences

Present law provides that, if an annuity is purchased for an employee by an exempt organization described in Code section 501(c)(3) or by a public school system, the employer's contributions for the annuity contract are excludable, within certain limitations, from the employee's gross income and not subject to tax until the employee receives payments under the annuity contract.

The bill would extend the same rule to qualifying annuities purchased for the civilian staff and faculty of the Uniformed Services University of the Health Sciences, which was established by the Congress under the Department of Defense to train medical students for the uniformed services.

Description of Bill

Present law

If an annuity is purchased for an employee by an exempt organization described in Code section 501(c)(3) or by a public school system, the employer's contributions for the annuity contract are, within certain limitations, excludable from the employee's gross income and not subject to tax until the employee receives payments under the annuity contract (sec. 403(b)). Subject also to limitations generally applicable to tax-qualified retirement plans, the amount excludable in any year cannot exceed 20 percent of the employee's current annual compensation times the number of years of service, less amounts contributed tax-free in prior years.

In P.L. 92–426, Congress authorized establishment (under the Department of Defense) of the Uniformed Services University of the Health Sciences in order to train medical students for the uniformed services. This legislation authorizes hiring civilian faculty and staff members at salary schedules and with retirement benefits similar to those given to the faculty and staff of medical schools in the Washington, D.C. area. On July 15, 1975, the Secretary of Defense approved a tax-deferred annuity program for the faculty, similar to annuities available at certain medical schools in the Washington area and throughout the United States. However, because the University is a Federal instrumentality and is not an exempt organization described in section 501(c)(3), the annuities do not qualify under present law for tax deferral pursuant to section 403(b).

Issue

The issue is whether annuities purchased for the civilian faculty and staff of the Uniformed Services University of the Health Sciences should qualify for income tax deferral in the same manner as annuities purchased for employees of exempt organizations described in section 501(c)(3) or of public school systems.

Explanation of the bill

The bill would treat otherwise qualified annuities purchased for the civilian staff and faculty of the Uniformed Services University of the Health Sciences in the same manner for income tax purposes (sec. 403(b)) as employee annuities purchased by section 501(c)(3) organizations or by public school systems. Any qualified annuity purchased by the University would be subject to the same limitations as other annuities described in section 403(b).

Effective date

The provisions of the bill would apply to annuities purchased for service performed after December 31, 1979, in taxable years ending after that date.

Revenue effect

It is estimated that the bill would decrease budget receipts by less than $1 million per year.

Prior Congressional action

In the 95th Congress, an identical bill (H.R. 12606) passed the House, but was not acted upon by the Senate Finance Committee or considered by the Senate.

4. H.R. 7009—Messrs. Rostenkowski, Stark, Lederer, Fowler, Duncan (Tenn.), and Vander Jagt

SUMMARY

Income Tax Exclusion for Certain Federal Scholarship Grants

Under present law, amounts received as scholarships or fellowship grants at educational institutions generally are excluded from gross income unless, as a condition to receiving such amounts, the recipient must agree to perform services for the grantor. Temporary legislation provides an exclusion for amounts received by members of a uniformed service entering the Armed Forces Health Professions Scholarship Program and similar programs before January 1, 1981.

In general, the bill would exempt from taxation scholarships received under Federal programs which require future Federal service by the recipients to the extent that the scholarships are used for tuition, fees, and related expenses.

Description of Bill

Present law

Code section 117 provides that amounts received as scholarships at educational institutions and amounts received as fellowship grants generally are excluded from gross income. This exclusion also applies to incidental amounts received to cover expenses for travel, research, clerical help, and equipment. However, 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. Educational grants are not excludible from gross income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor (Treas. Reg. § 1.117-4(c)).

Special legislation provides that members of a uniformed service participating in the Armed Forces Health Professions Scholarship Program, the Public Health Services program, and similar programs may exclude from gross income amounts received as scholarships under these programs. Participants in these programs must agree to work for their funding service after completion of their studies. This temporary exclusion will not apply to scholarships awarded students entering these programs after December 31, 1980. (This temporary exclusion was most recently extended by P.L. 96-167, enacted as part of H.R. 5224.)

Issue

The issue is whether, on a permanent basis, Federal scholarships conditioned on the recipients' future services as Federal employees should be includible or totally or partially excludable from gross income.

Explanation of the bill

The bill would provide that an amount, which is received by an individual as a grant under a Federal program and which would be excludible from gross income as a scholarship or fellowship grant, but for the fact that the recipient must perform future service as a Federal employee, would not be includible in gross income if the individual establishes that the amount was used for qualified tuition and related expenses.

The excludible qualified tuition and related expenses would be the amount used for tuition and fees required for the enrollment or attendance of the student at an institution of higher education and for fees, books, supplies, and equipment required for courses of instruction at that institution.

The bill would define an "institution of higher education" as a public or other nonprofit educational institution in any State which: (1) admits as regular students only individuals who have a certificate of graduation from a high school (or the recognized equivalent of such a certificate); (2) is legally authorized within the State to provide a program of education beyond high school; and (3) provides an educational program for which it awards a bachelor's or higher degree, provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized health profession.

Effective date

The exclusion provided by the bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce budget receipts by $8 million in fiscal year 1981, $17 million in fiscal year 1982, and $21 million in fiscal year 1984.

5. H.R. 4446—Messrs. Holland, Conable, Duncan (Tenn.), Vander Jagt, Gradison, Jenkins, Ford (Tenn.), Bafalis, and Fowler

SUMMARY

Method of Accounting for Railroad Track Assets

Under present law, the Internal Revenue Service allows the railroad industry to use the retirement-replacement-betterment (RRB) method of accounting for railroad track assets, which is the same method required for these assets by the Interstate Commerce Commission. Under the RRB method, when a new railroad line is laid, the costs (for rail, ties, ballast, fasteners, and labor) are capitalized, and these costs are not depreciated, but when replacements are made to an existing line, the replacement costs are deducted currently.

The RRB method is not codified as part of the Internal Revenue Code, but is recognized as an acceptable method in court decisions and Internal Revenue Service rulings. The bill would codify the RRB method, effective for taxable years ending after December 31, 1953.

Description of Bill

Present law

If a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, a current deduction of the cost generally is not allowed. Rather, the cost of the asset must be capitalized. If the asset is property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion and to obsolescence, the acquisition cost (less salvage value in excess of 10-percent of cost) generally can be deducted over the asset's useful life either ratably or pursuant to a permissible "accelerated" method under which larger deductions are allowable in the earlier years of use. This approach to the recovery of the cost of an asset is referred to as depreciation.

The railroad industry, however, generally uses for tax purposes what is called the "retirement-replacement-betterment" (RRB) method of accounting for railroad track (rail) and ties, and other items in the track accounts such as ballast, fasteners, other materials and labor costs. Although the RRB method is not specifically recognized as an allowable method of depreciation or accounting under the Internal Revenue Code, it has been allowed in court decisions and is recognized by the Internal Revenue Service in revenue rulings.[1] The Service's recognition of this method for tax purposes is based upon the requirement by the Interstate Commerce Commission (ICC) that this method be used for rate-making purposes. Although the ICC now requires use of the RRB method, it is presently considering a change to require the use of ratable depreciation.

For assets accounted for under the RRB method, when a new railroad line is laid, the costs (both materials and labor) of the line are capitalized. No depreciation is claimed on the original installation, but these original costs may be written off if this line is retired or abandoned. If the original installation is replaced with components (track, ties, etc.) of a like kind or quality, the costs of the replacements (both materials and labor) are deducted as current expense. When the replacement is of an improved quality, it generally is treated as a betterment, under which the betterment portion of the replacement is capitalized and the remainder is expensed.[2] Where rail and other

[1] Rev. Rul. 67–22, 67–1 C.B. 52; Rev. Rul. 67–145, 67–1 C.B. 54; Rev. Rul. 78–199, 78–1 C.B. 66.

[2] Railroads may also claim the regular 10-percent investment credit on their track costs, including both costs which are capitalized as costs of a new line (or a betterment) and those which are currently deducted replacement costs (Code secs. 48(a)(1)(B) and 48(a)(9), Regs. § 1.48–1(d)(4)).

track assets are retired, the salvage value (measured by fair market value) of the recovered materials is reflected as ordinary income.[3]

The operation of the RRB method can be illustrated by the following examples. If the original installation of a new rail line included a railroad tie which cost $3, this cost is capitalized and no ratable depreciation is allowed. When this tie is replaced with a tie which currently costs $20, the $3 original cost remains frozen and the $20 replacement cost is deducted currently. Where a betterment is involved, for example, where 100-pound rail is replaced with 150-pound rail which costs $120, under the RRB method the betterment portion ($40)[4] is capitalized and the replacement portion ($80) is deducted currently.

Issue

The issue is whether the retirement replacement-betterment method of accounting for railroad track assets should be codified as an acceptable method of depreciation for Federal income tax purposes.

Explanation of the bill

The bill would codify the retirement-replacement-betterment method of accounting for railroad track assets as an acceptable method of depreciation for Federal income tax purposes.

Effective date

The provisions of the bill would be effective for taxable years ending after December 31, 1953 (the general effective date of the Internal Revenue Code of 1954).

Revenue effect

It is estimated that this bill will have no effect on budget receipts. The estimate is based on the assumption that the Internal Revenue Service would not, without this legislation, require a change in the method of accounting for tax purposes to a ratable depreciation method from the presently accepted retirement-replacement-betterment method.

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[3] See, e.g., *Seaboard Coast Line Railroad Company, Successor by Merger to Atlantic Coast Line Railroad Company v. Commissioner*, 72 T.C. ——, No. 76 (August 22, 1979).

[4] The $40 betterment portion is computed as follows:

$$\frac{\text{150-lb. new rail less 100-lb. old rail}}{\text{150-lb. new rail}} \times \$120 \text{ cost of new rail} = \$40$$

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6. H.R. 6883--Messrs. Ullman, Conable, Rostenkowski, and Duncan (Tenn.)

Revision of the Rules Relating to Certain Installment Sales

(H.R. 6883, Messrs. Ullman, Conable, Rostenkowski, and Duncan of Tenn.)

The bill (H.R. 6883) would amend the rules for reporting gains under the installment method for sales of real property and casual sales of personal property. (An identical bill, S. 2451, has been introduced in the Senate by Senators Long and Dole.)

The bill would make the following changes:

(1) Structural improvements.—Under present law, a single provision (Code sec. 453) prescribes rules for installment method reporting for dealers in personal property, for sales of real property and nondealer personal property, and special disposition rules. Under the bill, the basic rules for nondealer transactions would be contained in one Code section (sec. 453), the rules for dealer transactions would be contained in another section (sec. 453A), and generally applicable installment obligation disposition rules would be contained in a third section (sec. 453B).

(2) Initial payment limitation.—The bill would eliminate the requirement that no more than 30 percent of the selling price be received in the taxable year of sale to qualify for installment sale reporting for gains from sales of realty and nondealer personal property.

(3) Two-payment rule.—The bill would eliminate the requirement that a deferred payment sale be for two or more payments. Thus, a sale will be eligible for installment reporting even if the purchase price is to be paid in a single lump sum amount in a year subsequent to the taxable year in which the sale is made.

(4) Selling price requirements.—The bill would eliminate the requirement that the selling price for casual sales of personal property must exceed $1,000 to qualify for installment sale reporting.

(5) Election.—The bill would eliminate the present law requirement that the installment method must be elected for reporting gains from sales of realty and nondealer personal property. Instead, the provision would automatically apply to a qualified sale unless the taxpayer elects not to have the provision apply with respect to a deferred payment sale.

(6) Related party sales.—The bill would prescribe special rules for situations where there is an installment sale to a related party who also disposes of the property.

Under the bill, the amount realized upon a resale by the related party installment purchaser would trigger recognition of gain by the initial seller, based on his gross profit ratio, only to the extent the amount realized from the second disposition exceeds actual payments made under the installment sale. Thus, acceleration of recognition of the installment gain from the first sale would generally result only to the extent additional cash and other property flows into the related group as a result of a second disposition of the property.

The excess of any amount realized from resales over payments received on the first sale as of the end of a taxable year would be taken into account. Thus, the tax treatment would not turn on the strict chronological order of when resales or payments are made. If, under these rules, a resale results in the recognition of gain to the initial seller, subsequent payments actually received by that seller would be recovered tax-free until they equaled the amount realized from the resale which resulted in the acceleration of recognition of gain.

In the case of property other than marketable stock and securities, the resale rule would apply only with respect to second dispositions occurring within 2 years of the initial installment sale. In the case of marketable stock and securities, the resale rule would apply without a time limit for resales occurring before the installment obligation is satisfied.

The bill also contains several exceptions to the application of these rules. Since gain from the sale of a corporation's treasury stock is nontaxable and therefore its basis in the stock is irrelevant, the related party rule will not apply to any sale or exchange of stock to the issuing corporation. In addition, there generally would be no acceleration of recognition of gain as a result of a second disposition which is an involuntary conversion of the property or which occurs after the death of the installment seller or purchaser. Finally, the resale rules would not apply in any case where it is established to the satisfaction the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of Federal income taxes.

For purposes of the related party rules, the bill adopts a definition of related parties which will include spouses, children, grandchildren, and parents but will exclude brothers and sisters. However, it is to be understood that the omission of a specific family relationship is not intended to preclude the Internal Revenue Service from asserting the proper tax treatment to transactions that are shams.

(7) Like-kind exchanges.—The bill would provide that the receipt of like-kind property in connection with a disposition will not be taken into account in determining gain recognized for installment sale reporting purposes. Under the present Internal Revenue Service position, the receipt of like-kind property results in the recognition of installment gain before cash is received by the taxpayer because the value of such property is treated as a payment received. The bill would reverse this rule.

(8) Installment obligations distributed in a corporate liquidation.—The bill would provide nonrecognition of gain treatment for a shareholder who receives installment obligations as liquidating distributions from a corporation liquidating within 12 months of adoption of a plan of liquidation. In general, this rule would apply to obligations arising from sales by the corporation during the 12-month period. Obligations from the sale of inventory would qualify only if the inventory of that trade or business is sold in bulk. The gain realized by the shareholder on his stock would be recognized as payments are received on the installment obligation. Thus, in most significant aspects, the tax consequences to a shareholder would be essentially the same whether the corporation sells its assets and then distributes installment obligations in liquidation or the shareholder makes an installment sale of the stock.

(9) Sales subject to a contingency.—The bill would permit installment sale reporting for sales for a contingent selling price. Under present law, these sales are not eligible for installment reporting. In extending eligibility, the bill does not prescribe specific rules which would apply to every conceivable transaction. Rather, the bill provides that the specific rules will be prescribed under regulations.

However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined by reference to the stated maximum selling price. In cases where the sales price is indefinite but payable over a fixed period of time, it is generally intended that the basis of the property sold would be recovered ratably over that fixed period. In cases where the selling price and payment period are both indefinite, it is intended that the regulations would permit ratable basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type period.

(10) Cancellation of installment obligation.—The bill would make it clear that the cancellation of an installment obligation other than by death is treated as a disposition of the obligation by the holder of the obligation.

(11) Bequest of obligation to obligor.—The bill would provide that the installment obligation disposition rules cannot be avoided by bequeathing an obligation to the obligor.

(12) Foreclosure of real property sold on installment method by deceased taxpayer.—The bill would provide that an executor or beneficiary who receives a secured installment obligation from a decedent will succeed the decedent for purposes of qualifying for nonrecognition treatment if the real property sold is reacquired in cancellation of the obligation.

(13) Effective dates.—In general, the bill would be effective for sales, cancellations, bequests, and reacquisition of real property, as the case may be, occurring after the date of enactment. However, the related party installment sale rules would apply to installment sales after March 31, 1980. The provision relating to the distribution of installment obligations in connection with a 12-month corporate liquidation would apply with respect to plans of liquidation adopted after the date of enactment.

Revenue Effects

Due to the interaction between the provisions of this bill, revenue effects for each specific provision cannot be determined. It is estimated that on balance the provisions of this bill (except related party sales) will not have a significant revenue effect on budget receipts.

Due to the litigious nature of related party sales under present law, the revenue gain for this provision of the bill is indeterminant.

7. H.R. 5716—Messrs. Fisher and Butler

SUMMARY

Tax Treatment for Consolidated Return Purposes of Stock in Certain Transferor Railroads in the ConRail Reorganization

Under present law, net operating losses of a member of an affiliated group of corporations controlled by a common parent corporation may be used to offset income reported by other members of the affiliated group where consolidated income tax returns are filed by the group. In order to reflect the reduction in tax liabilities derived by the other members of the affiliated group, the basis in the loss corporation's stock owned by other members of the group is reduced by these operating losses, and, where these losses exceed basis, a negative basis (called an excess loss account) is created. The excess loss account is restored to income when the other members of the affiliated group sell their stock in the loss corporation or when the loss corporation becomes insolvent.

The bill would specify that, for purposes of the consolidated return rules, the determination of worthlessness of stock in a corporation which was a transferor railroad in the April 1, 1976, ConRail reorganization will not occur until after a final determination of the value of the transferred rail properties by a special court formed for this purpose.

The only known beneficiary of this bill is the affiliated group of corporations controlled by Norfolk and Western Railway Company, Inc. This affiliated group filed consolidated income tax returns and included Erie Lackawanna Railway Company, one of the bankrupt transferors of rail properties to ConRail in the April 1, 1976, ConRail reorganization. The Erie Lackawanna Railway Company was wholly owned by another member of the Norfolk and Western affiliated group. Its net operating losses have been used to offset income reported by other members of the group and resulted in the creation of an excess loss account. The Internal Revenue Services has indicated that this excess loss account should be restored to income for the 1976 consolidated return year of the Norfolk and Western affiliated group.

Description of Bill

Present law

On April 1, 1976, a number of insolvent midwestern and eastern 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 [1] 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. Valuation of the transferred railroad properties, and the corresponding value of the certificates of value received by the transferor railroads, is to be determined ultimately by a special court created for this purpose.

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,[2] the transfer of rail properties to Co-

[1] 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).

[2] P.L. 94-253, approved March 31, 1976.

Rail 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 (Code sec. 374(c)).

The 1976 tax legislation did not deal with certain other aspects of the ConRail reorganization such as investment credit recapture to the transferor railroads which arose from the mandated transfer of assets to ConRail. To deal with this aspect of the ConRail reorganization, the Revenue Act of 1978 (P.L. 95-600, approved November 6, 1978) added an exception to the investment credit recapture rules so that a transferor railroad will not be subject to recapture of the investment credit because of its transfer of railroad properties to ConRail.

Present law also provides rules which deal with the filing of consolidated returns by affiliated groups of corporations.[3] Under the section 1502 consolidated return regulations, income tax liability generally is based on the combined income of the corporations in the affiliated group. Where one or more members of the affiliated group have incurred net operating losses, these losses offset taxable income of other members of the affiliated group, and the tax basis of their stock investment in the loss corporation is reduced generally by the allocated portion (based on stock ownership) of the losses reflected on the consolidated return. If the losses used on the consolidated returns exceed the basis of the stock owned by other members of the group, the result is the creation of excess loss accounts which are the equivalent of negative basis in the stock of the loss corporation owned by the other members.

Where there is a disposition of the loss affiliate's stock or the stock ownership requirements are not met, any excess loss accounts in existence at that time are "restored" by treating them as income.[4] The term disposition is broadly defined and includes the occurrence of worthlessness or insolvency of the loss affiliate. In these situations, ordinary income will generally be recognized through triggering the excess loss account and special rules are provided for determining insolvency in situations concerning excess loss accounts. Where an excess loss account is restored, there is no provision in present law for revival of the previously used net operating loss by the loss affiliate.

Issue

The issue is whether a rule should be provided concerning the application of the consolidated return regulations to an affiliated group which included a transferor railroad in the ConRail reorganization.

Explanation of the bill

The bill would provide a statutory rule, for purposes of applying the consolidated return regulations, under which the determination of worthlessness of the capital stock of a transferor railroad in the ConRail reorganization is postponed until a determination of value by the special court becomes final.

The only known beneficiary of this bill is DERECO, Inc., a member of an affiliated group of corporations with the Norfolk and Western Railway Company, Inc., the parent corporation in this group. DERECO, Inc. is a wholly owned subsidiary of Norfolk and Western Railway Company, Inc. and is the sole stockholder of the Erie Lackawanna Railway Company, one of the transferor railroads in the ConRail reorganization. During a period of years Erie Lackawanna Railway Company, as a member of the Norfolk and Western affiliated group, was included in consolidated income tax returns filed by the

[3] These rules are primarily set forth in regulations promulgated under specific statutory authority (Code sec. 1502). An affiliated group of corporations is generally defined as a group of corporations connected with a common parent corporation through ownership of at least 80 percent of the voting power of all classes of voting stock and at least 80 percent of each class of nonvoting stock. However, certain corporations are generally not included in an affiliated group (Code sec. 1504).

[4] These rules are necessary in order to reflect the reduction in tax liability the other members of the affiliated group have derived through use of the losses.

group. Erie Lackawanna Railway Company reported substantial net operating losses which were used in the consolidated returns to offset taxable income reported by other members of the Norfolk and Western group. These losses reduced the basis of the Erie Lackawanna stock owned by DERECO, Inc. to zero and resulted in the creation of an excess loss account.

During 1972, Erie Lackawanna Railway Company entered into bankruptcy proceedings and eventually became one of the railroads which transferred rail properties to ConRail on April 1, 1976. The Internal Revenue Service has taken the position that the excess loss account of DERECO, Inc. will be restored to income for the 1976 consolidated return year of the Norfolk and Western affiliated group of corporations.[5]

Effective date

The provisions of the bill would apply to taxable years ending after March 31, 1976.

Revenue effect

The revenue effects of the bill are indeterminate with respect to both the amount of tax involved and the timing of tax payment. If the excess loss account were restored to income for the 1976 tax year, the taxpayer would incur an additional tax liability of about $15 million. However, the amount of estimated tax liability, if any, may be adjusted after the determination of value by the special court. Because the taxpayer is expected to oppose assertion of a deficiency for its 1976 tax year, there would be an effect on budget receipts only if the taxpayer's position were not sustained and this occurred before the determination of the value by the special court became final.

[5] The trustees in bankruptcy of the Erie Lackawanna Railway Company have proposed that the previously used net operating losses of Erie Lackawanna be revived to the extent the excess loss account is restored to income of the Norfolk and Western affiliated group.

Additional Item for Subcommittee Consideration

The Subcommittee may wish to consider whether the benefit of net operating losses which were used on a consolidated return for the Norfolk and Western affiliated group and which are restored as income by triggering an excess loss account should be correspondingly restored to the Erie Lackawanna Railway Company to apply against any income ultimately recognized by it.

8. H.R. 5616—Messrs. Coelho, Corman and Others

SUMMARY

Excise Tax Treatment for Wine Used in Distilled Spirits Products

Prior to January 1, 1980 (the effective date of the distilled spirits tax provisions of P.L. 96–39, the Trade Agreements Act of 1979), wine was generally subject to the applicable wine excise tax when it was withdrawn from the bonded wine cellar where it was produced. Where wine was used in the production of a distilled spirits product, the wine was taxed at the lower wine excise tax rate prior to blending with the distilled spirits. The distilled spirits component of a product was similarly taxed prior to blending at the distilled spirits tax rate ($10.50 per proof gallon). Also, a 30-cent per proof gallon rectification tax was imposed on the blended product.

The 1979 Act modified the excise tax treatment of distilled spirits products so that the final distilled spirit product (including wine and alcoholic flavorings) is taxed on the alcohol (proof) content of the final product at the $10.50 per proof gallon distilled spirits tax rate. This method is known as the "all-in-bond" system.

The bill would provide a credit against the excise tax liability under the all-in-bond method for the difference between the distilled spirits tax ($10.50 per proof gallon) and the applicable wine excise tax on the wine used in the distilled spirits product as if the wine had been subject to the wine tax (as generally imposed under Code sec. 5041 but for its removal to bonded premises). The credit would be available for domestically produced products and imported distilled spirits products containing wine, and would be effective on January 1, 1980.

Description of Bill

Present law

Excise tax rates on wine

The excise tax on wine depends on the alcohol content (by volume) and whether the wine is carbonated or non-carbonated (still wine). Still wines are taxed as follows: (a) 17 cents per wine gallon for wines containing not more than 14 percent alcohol; (b) 67 cents per wine gallon for wines containing more than 14 percent and not more than 21 percent alcohol; and (c) $2.25 per wine gallon for wines containing more than 21 percent and not more than 24 percent alcohol. Champagne and other sparkling wines are taxed at $3.40 per wine gallon and artifically carbonated wines are taxed at $2.40 per wine gallon. (All wines containing more than 24 percent alcohol by volume are classed and taxed as distilled spirits—at $10.50 per proof gallon.)

Method of taxing wine used in distilled spirits products

One use for wine is to combine it with distilled spirits to produce distilled spirits products, such as blended whiskeys, cordials and liquers. Under law in effect prior to January 1, 1980, wine used to produce distilled spirits products was subject to the applicable wine tax when this wine was withdrawn from the bonded wine cellar where it was produced. The distilled spirits tax of $10.50 per proof gallon was correspondingly imposed on the distilled spirits before the wine and distilled spirits components were blended to produce the distilled spirits product. In addition, a 30-cent-per-proof gallon rectification tax was generally imposed on the blended product. Prior law also included provisions under which alcoholic flavorings used to produce distilled spirits products were subject to an effective rate tax of $1.00 per proof gallon before they were blended into a distilled spirit product.

The Trade Agreements Act of 1979 (P.L. 96-39, approved July 26, 1979) generally implements the trade agreements reached under the multilateral trade negotiations. A part of this legislation equalizes the U.S. excise tax treatment of U.S. and foreign-produced distilled spirits and modernizes the system for imposing and administering the distilled spirits tax. This new system is referred to as the "all-in-bond" method and was generally effective on January 1, 1980. Under the all-in-bond method wine used to produce distilled spirits products is not subject to the wine tax. Instead, this wine is transferred in bond (before any tax is determined) to the distilled spirits plant where it becomes part of a distilled spirits product. The distilled spirits tax is then imposed on the completed product including the wine component. (The 30-cent rectification tax was also repealed under the all-in-bond changes.)

A result of the change to the all-in-bond method is that alcohol in wine which is included in a distilled spirits product is subject to the $10.50 per proof gallon distilled spirits tax, rather than the generally lower total of the applicable wine tax and the prior rectification tax.[1] The distilled spirits tax is also similarly imposed on any alcoholic flavorings which are part of the blended product.

Issues

The main issue is whether wine used in distilled spirits products should be taxed on its alcohol (proof) content as under the all-in-bond method or as it was prior to the Trade Agreements Act of 1979. If a credit were allowed, another issue would be the timing of the credit for domestically produced and imported spirits containing wine. In addition there is an issue as to whether alcoholic flavoring used in distilled spirits products should be accorded the lower effective rates of tax which existed under prior law.

Explanation of the bill

The bill would provide a credit against excise tax liability under the all-in-bond method for the difference between the distilled spirits tax ($10.50 per proof gallon) and the applicable wine tax on this wine if the wine had been subject to the wine tax (as imposed under Code sec. 5041 but for its removal to bonded premises). The credit would be available only on wine which becomes part of a distilled spirits product and would be determined, in the case of domestically produced distilled spirits products, when the wine is dumped for processing and would be allowed for the return period in which the wine is so dumped. This credit would also be available for wine included in distilled spirits products which are produced abroad and imported into the United States and would be determined and allowed at the time the distilled spirits tax is imposed.

The wine content of imported distilled spirits would be established by such chemical analysis, certification, or other method as may be set forth in regulations.

Effective date

The provisions of the bill would be effective on January 1, 1980, the same date when the all-in-bond method became effective under the Trade Agreements Act of 1979.

Revenue effect

It is estimated that the bill would reduce budget receipts by at least $5 million annually from the amount that would be collected under the all-in-bond method.

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[1] Although P.L. 96-39 was effective on January 1, 1980, the Bureau of Alcohol, Tobacco, and Firearms (ATF) of the Treasury Department issued a temporary rule (45 *Fed. Reg.* 7528, Feb. 1, 1980; Treas. Dec. ATF-64) deferring the payment of the distilled spirits tax attributable to the wine component of distilled spirits products. This deferral applied only to the first three semi-monthly return periods for spirits withdrawn during 1980, but the tax so deferred was due and payable on March 20, 1980; no further extension has been granted.

Other Congressional action

The Senate Finance Subcommittee on Taxation and Debt Management Generally held a hearing on an identical bill (S. 1913, introduced by Senators Cranston and Hayakawa) on December 19, 1979. On March 4, 1980, the Senate approved a similar amendment (by Sen. Cranston) to H.R. 4612 (relating to Social Security benefits for disabled children). For domestically produced spirits, the Senate amendment to H.R. 4612 would determine the credit at the time the tax is determined on the distilled spirits containing such wine and would allow the credit for the return period in which the distilled spirits tax is payable. For imported spirits, the amendment would be determined and allowed when the distilled spirits tax is imposed. (as in H.R. 5616). H.R. 4612 is awaiting a House-Senate conference.