[JOINT COMMITTEE PRINT]

DESCRIPTION OF MISCELLANEOUS TAX BILLS LISTED FOR A HEARING

BEFORE THE

SUBCOMMITEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON AUGUST 4, 1980

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

JULY 30, 1980

U.S. GOVERNMENT PRINTING OFFICE

65-589 O WASHINGTON : 1980 JCS-35-80

CONTENTS

JOINT COMMITTEE ON TAXATION

2

33

34

35

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on August 4, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. The are four Senate bills and three sections of a House-passed bill (H.R. 7171) described in the pamphlet.

The first part of the pamphlet is a summary of the bills presented in bill numerical order for Senate bills and then for the sections of the House-passed bill. This is followed by a more detailed description of the bills, setting forth present law, the issues involved, an explanation of the bills, the effective dates, and the estimated revenue effects.

I. SUMMARY OF BILLS

A. SENATE BILLS

1. S. 2775—Senators Bentsen, Talmadge, Moynihan, Baucus, Dole, Chafee, and Wallop

Nonqualified Deferred Compensation Plans for Nonresident Aliens

The bill would provide special rules for nonqualified plans of deferred compensation primarily for the benefit of persons substantially all of whom are nonresident aliens. These provisions would govern the allowability of deductions with respect to the plans and the effect of the plans on a corporation's earnings and profits. Also, trusts under the plans would be exempted from certain rules relating to foreign trusts with U.S. beneficiaries.

2. S. 2805—Senator Nelson

Deferred Application of Revenue Procedure 80–5 and Revenue Ruling 80–60 Relating to Inventory Writedowns

Revenue Procedure 80–5 and Revenue Ruling 80–60 require taxpayers to conform their method of inventory accounting to that method of inventory accounting approved by the Supreme Court in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979). For taxpayers with excess inventories (inventories in excess of foreseeable demand) that have been erroneously written down for tax purposes, these pronouncements require that the writedowns be taken back into income.

The Internal Revenue Service pronouncements were issued on February 8, 1980, and are applicable to 1979 taxable years. Taxpayers contend that by waiting until 1980 to release the pronouncements, the IRS has prevented them from being able to comply in 1979 with certain Treasury regulations that would have mitigated the income recapture required under the *Thor Power* decision. This bill would delay the implementation of Revenue Procedure 80–5 and Revenue Ruling 80–60 to taxable years beginning after 1979 and would give taxpayers the opportunity to take mitigating action under the Treasury regulations.

3. S. 2818—Senators Talmadge, Baucus, and Pryor

Tax Treatment of Mutual or Cooperative Telephone and Electric Companies

The bill would provide that, in determining whether a mutual or cooperative telephone or electric company meets the 85-percent member-income requirement for tax exemption (under Code sec. 501(c)(12)), any income from rental of poles (used in the cooperative's exempt activities) or from display listings in a directory is to be disregarded. The bill also would provide that income from the rental of such poles by mutual or cooperative telephone and electric companies is not subject to the tax on unrelated business taxable income.

4. S. 2904—Senators Talmadge, Glenn, and Dole

Adjustments in Excise Tax on Tires

Present law imposes an excise tax of 10 cents per pound on new highway tires (to be reduced to 5 cents per pound on October 1, 1984), and 5 cents per pound on new nonhighway tires. A credit or refund is allowed with respect to tires for which a warranty or guarantee adjustment is made. However, there are no specific statutory provisions as to the proper method of computing the credit or refund.

The bill would reduce the excise taxes on new tires by 2.5 percent, beginning on January 1, 1981, and disallow an excise tax credit or refund with respect to tires for which a warranty or guarantee adjustment is made after December 31, 1982. The bill also would provide a special rule for determining a credit or refund for tires which are adjusted after March 31, 1978, and prior to January 1, 1983. In this period, a credit or refund would be determined under the IRS administrative guidelines in effect on March 31, 1978.

B. CERTAIN SECTIONS OF HOUSE-PASSED BILL, H.R. 7171

1. Section 1.—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, this provision of the bill exempts 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.

2. Sections 4 and 5.—Tax Treatment for Members of an Affiliated Group which Included a Transferor Railroad in the Con-Rail 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 a consolidated income tax return is 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, for example, the loss corporation ceases to be a member of the affiliated group or the stock of the loss corporation becomes worthless.

Section 4 of the bill specifies that, for purposes of determining when an excess loss account is restored to income under 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. This provision is intended to benefit the Norfolk and Western Railway Company.

In addition, section 5 of the bill provides that, to the extent an excess loss account arising from net operating losses of a ConRail transferor railroad from periods before or including the taxable year of the ConRail reorganization is restored as ordinary income (or its equivalent in capital gain income), the transferor's net operating losses will correspondingly be restored to the transferor railroad to apply solely against any income ultimately recognized by the transferor railroad from the ConRail reorganization. This provision is intended to benefit the Erie Lackawanna Railway Company.

II. DESCRIPTION OF BILLS

A. SENATE BILLS

1. S. 2775—Senators Bentsen, Talmadge, Moynihan, Baucus, Dole, Chafee, and Wallop

Nonqualified Deferred Compensation Plans for Nonresident Aliens

Present law

United States businesses operating abroad often provide deferred compensation for their foreign employees. In many cases, plans are established which cover almost exclusively nonresident alien employees, rather than U.S. citizens working abroad. The foreign operations of the U.S. business may be conducted through a branch of a U.S. corporation or through a foreign subsidiary of a U.S. parent corporation.

General rules relating to deductibility of deferred compensation

In general, the year in which a taxpayer is allowed to deduct expenses, such as compensation, is determined by its method of accounting. Generally, cash basis taxpayers deduct expenses in the year they are paid, while accrual basis taxpayers deduct the expenses in the year in which all events have occurred which determine the fact of the liability and the amount of the liability can be estimated with reasonable accuracy.

However, the Code provides special rules (sec. 404) for deductions of amounts under pension and other deferred compensation plans, which must be met in addition to the usual requirements for deduction of the amounts as business expenses (secs. 162 and 212). Separate rules apply with respect to qualified and nonqualified deferred compensation plans.

Qualified plans.—In order for a deferred compensation plan to be "qualified" under the Code, contributions under it must be paid into a trust to protect them from the employer's creditors. A number of other requirements must also be met. In particular, the plan must be administered for the sole benefit of employees and their beneficiaries, eligibility to participate must be nondiscriminatory, contributions or benefits must be nondiscriminatory, and benefits must be paid no later than specified dates. Additional requirements must be met if the plan covers self-employed individuals, such as partners. The Employee Retirement Income Security Act of 1974 (ERISA) added a number of additional requirements, including, for example, new eligibility rules, minimum standards for vesting and accrual of benefits, minimum funding standards, maximum limitations on contributions and benefits, a requirement that benefits be paid in certain cases in the form of joint and survivor annuities, and prohibitions on certain dealings between the plan and related parties.

If a plan is qualified, a deduction is allowed at the time a contribution is paid into the plan's trust. The amount of the contribution allowable as a deduction is no less than the amount necessary to satisfy the minimum funding standard prescribed by ERISA. A maximum limitation is also placed on the amount of the contribution which may be deducted. Generally, this may not exceed the "normal cost" of the plan for the year plus an amount which would amortize plan benefit liabilities attributable to past service of employees (if not already included in normal cost under the funding method used by the taxpayer) over a period of no less than 10 years. (The "normal cost" is a measure intended to reflect the ratable share of the increase in plan liabilities to participants resulting from service performed that year. Under some allowable funding methods, a ratable portion of liability for past service of the employees is also included in the year's normal cost). No deduction is allowed for contributions in excess of the "full funding limitation," the amount by which the accrued liability for benefits of the plan exceeds the value of its assets. Other limitations on deductions also apply if the employer maintains qualified profit sharing or stock bonus plans for his employees. An unlimited carryforward is allowed for contributions in excess of the limitations.

Nonqualified plans.—If a plan of deferred compensation does not meet the requirements for qualification under the Code, a separate rule applies to the deductibility of contributions. The deduction is taken in the taxable year in which an amount attributable to the contribution is includible in the income of the employee. A similar rule applies to deferred compensation arrangements with independent contractors. However, if the plan covers more than one employee, the deduction may be taken only if separate accounts are maintained for each employee. Otherwise, the IRS takes the position that the contribution is never deductible, except in the case of unfunded plans where payment is made directly to the former employees.

Separate accounts are established only for defined contribution plans, which generally require that an amount established pursuant to a formula, which may vary from employee to employee, be contributed to the accounts of the participants. Each employee bears the risk of fluctuations in the value of the investments in his account. Separate accounts are not maintained, however, for defined benefit plans. These plans specify by formula the benefits which participants are to receive on retirement. Contributions to them are based on actuarial calculations of the amounts which will be required to be paid out, generally based in the aggregate on the ages and life expectancies of members of the workforce, likely turnover of participants, and expected investment performance of amounts contributed. The employer bears the risk of investment gain or loss. Because the actuarial assumptions are based on aggregate data, no separate accounts are maintained. Hence, in situations where this rule applies, no deduction is allowed for contributions to a defined nonqualified benefit plan.

Foreign deferred compensation plans

Foreign branch operations.—The Code permits the trust of a qualified plan to be organized under foreign law but does not otherwise expressly waive any of the requirements for qualification. In Letter

Ruling 7904042, the Internal Revenue Service held that if a plan for the benefit of nonresident alien employees did not meet all of the requirements for qualification under the Code (including the provisions added by ERISA), no deduction would be allowable under the rules for qualified plans described above. Instead, the Service held that amounts would be deductible, if at all, only under the rules which apply to nonqualified plans. Since the plans in question were defined benefit plans which did not maintain separate accounts for participants, the Service denied deductions for contributions made to the plans.

Foreign subsidiary operations.—Foreign subsidiaries of U.S. corporations generally do not have U.S. operations which would subject them to U.S. tax, and since their income is thus not subject to U.S. tax, the question of whether a deduction is allowed for contributions to a plan for nonresident aliens does not have the same direct effect on their U.S. tax liability as in the case of a foreign branch of a U.S. corporation. However, the treatment of the contribution in computing the foreign subsidiary's accumulated profits has important consequences in determining the indirect foreign tax credit which the U.S. parent corporation is allowed with respect to dividends received from the foreign subsidiary.[1]

Generally, if a U.S. corporation owns at least 10 percent of the voting stock of a foreign corporation from which it receives a dividend, the U.S. corporation is deemed to pay the amount of foreign income taxes paid by the foreign subsidiary on the accumulated earnings from which the dividend was paid. The U.S. corporation may then, within limitations, claim a credit against its U.S. tax liability in the amount of the foreign income taxes deemed paid by it. Under regulations, the determination of foreign taxes paid on accumulated earnings is made on a year-by-year basis, starting with the most recent year. If only part of the accumulated earnings of that year are paid out, only a proportionate part of the foreign income taxes paid with respect to the earnings for that year are deemed paid. Thus, if a dividend of a given size is paid, more of the foreign income taxes paid by the foreign subsidiaries will be deemed to have been paid by (and thus would be creditable by) the U.S. parent if the accumulated earnings of the subsidiary are smaller than if they are larger—because a proportionately larger share of the accumulated earnings would be paid out in the dividend, resulting in a greater proportion of the foreign taxes being deemed paid.

The deduction issue discussed in connection with foreign branches can also be relevant in the case of a foreign subsidiary if it conducts a U.S. business, the taxable income from which must be determined, or if it is a controlled foreign corporation (CFC).[2]

In the case of a CFC, subpart F (secs. 951–64 of the Code) provides that, in general, the United States shareholders must currently include in their income certain types of tax haven income of the corporation

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[1] Section 406 of the Code permits, in limited instances, a U.S. parent corporation with a qualified plan to make contributions on behalf of employees of a foreign subsidiary who are U.S. citizens. In such cases, a deduction is allowed to the foreign subsidiary.

[2] Generally, a foreign corporation is a CFC if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom holds 10 percent or more of the voting power.

and certain types of passive investment income. Generally, the amount of this income to be taken into account is reduced by deductions properly allocable to that income, so if foreign pension costs are so allocable, it is necessary to determine whether and when they are deductible. Moreover, an indirect foreign tax credit similar to that described above may be allowed to the U.S. shareholder with respect to the amount which the shareholder must include in income. The credit is equal to the proportionate part of the foreign income taxes paid on the earnings and profits of the CFC from which the distribution is deemed to be made. Thus, questions similar to those described above arise as to the size of the earnings and profits.

In Letter Ruling 7839005, the Internal Revenue Service considered an accrual basis CFC which established an irrevocable balance sheet reserve for pension expenses. The taxpayer contended that the CFC's earnings and profits should be reduced by the amount of its pension liability which had properly been accrued. The Service held, however, that earnings and profits could be reduced only to the extent of pension payments actually made. The Service did not view as controlling the taxpayer's argument that this result would distort (generally by reducing) its allowable indirect foreign tax credit with respect to dividend distributions from the CFC.

Foreign trusts with U.S. beneficiaries.—The Code provides that if a U.S. person transfers property to a foreign trust, and a U.S. person is the beneficiary of any part of the trust, then the transferor is treated as the owner of the transferred trust property and therefore is taxable on the income earned on that part. Moreover, if the trust does not have a U.S. beneficiary at the time of the transfer but later acquires one, the transferor is subject to tax on all the undistributed net income on amounts it previously transferred to the trust. The Code expressly provides that these rules do not apply to foreign trusts established under qualified plans. However, there is no similar exception for foreign trusts under nonqualified plans. Thus, if a U.S. corporation makes a contribution to a foreign trust of a nonqualified plan, it is possible that the corporation would be taxable on the income earned on the contribution, either immediately if the trust has a U.S. person as a beneficiary, or subsequently if one of the plan participants or his beneficiary becomes a U.S. citizen or resident.

Issues

The issues are whether or not, in the case of a nonqualified plan of deferred compensation maintained for the benefit of nonresident aliens:

(1) special rules should be prescribed with respect to the allowability of deductions with respect to the plan;

(2) special rules should be prescribed as to the effect of the plan on earnings and profits; and

(3) it should be specified that the rules relating to foreign trusts with U.S. beneficiaries do not apply to contributions to such a trust under the plan.

Explanation of provisions

Allowance of deductions

The bill would provide that, in the case of a nonqualified deferred compensation plan which is maintained primarily for the benefit of persons substantially all of whom are nonresident aliens, the general rules regarding the timing and allowability of deductions for contributions will not apply (unless the taxpayer elects to have those rules apply to the plan). Instead, if the contributions otherwise qualify for deduction as business expenses, special rules for deductibility are prescribed.

General rules.—Four general requirements apply to any deductions (except deductions for direct payments, described below) to be taken under the special rules. First, the benefits provided by the plan must be either required by foreign law or set forth in a written document communicated to the active participants. Second, in the case of a defined benefit plan, the deduction is limited to amounts paid or accrued in respect of benefits that are reasonably capable of actuarial estimation. Third, to the extent the amount taken into account is dependent upon actuarial determinations, the actuarial cost method and assumptions used must in the aggregate be reasonable. Fourth, the amount to be taken into account for the taxable year must be determined in a manner consistent with generally accepted accounting principles in the United States applicable to the charging of pension costs against income.

In addition to these general requirements, special rules are prescribed which must be met in both of the circumstances which could give rise to a liability for deferred compensation other than a direct payment: the payment of contributions to a trust or fund on the one hand, and other payment or accrual on the other hand.

Trust contributions.—If an amount is transferred to a separate trust or fund and has not been allowed previously as a deduction, then, whether or not benefits to be provided from the trust are subject to a substantial risk of forfeiture, a deduction is allowed for the amount transferred if the conditions described above under "General rules" are met and if certain other requirements are met. In the case of a defined benefit plan, the amount transferred and any income earned thereon must not revert to the employer or to the employer's benefit prior to the satisfaction of all liabilities with respect to participants and beneficiaries under the plan. Also, the transferred amount must not exceed the full funding limitation for the year. In the case of a defined contribution plan, the amount transferred and any income earned thereon must not revert to the employer or to employer's benefit, and the amount taken into account must be allocated to individual accounts of participants that will be adjusted at least annually for the income and expenses of the fund. As is currently the case with qualified plans, a taxpayer will be allowed a deduction with respect to a taxable year if the contribution on which the deduction is based is made by the time the taxpayer files a timely return for that year.

Other payments and accruals.—If the above requirements relating to payment into a trust or fund are not met, but the conditions described above under "General rules" are satisfied, then a deduction is allowed at the time of payment or accrual, if the amount is paid or accrued in respect of benefits that are not subject to a substantial risk of forfeiture, and, if the amount is accrued, it represents the actuarial present value of such accrued benefits.

Direct payments.—The bill also provides that, if a deduction has not previously been allowed under the above rules, it will be allowed when a payment, which is not subject to a substantial risk of forfeiture, is made to a participant or beneficiary by an employer.

Nonresident alien participation.—As described earlier, these rules apply only where substantially all of the beneficiaries are nonresident aliens. The bill provides for a reduction of the deduction otherwise allowable where not all the active participants are nonresident aliens. Generally, the amount otherwise allowable is to be multiplied by a fraction, the numerator of which is the payments or accruals made on behalf of active participants who are nonresident aliens, and the denominator of which is the payments or accruals made on behalf of all active participants. However, no reduction is required if during the taxable year at least 95 percent of all active participants are nonresident aliens, and at least 95 percent of the contributions made to or benefits accruing under the plan are in respect of active participants who are nonresident aliens.

Other rules.—The bill allows an unlimited carryforward of amounts not currently deductible (except amounts disallowed because of the participation of individuals other than nonresident aliens). The bill also requires that whatever accounting method is used to determine the deductible amount must be used consistently. Changes in the accounting method (but not actuarial assumptions) would require the permission of the Service.

Effect on earnings and profits

The bill would provide that, if an amount would be deductible under the special rules provided by the bill, the earnings and profits of the corporation are to be reduced to the same extent.

Foreign trusts

The bill would make it clear that in the case of a contribution to a foreign trust subject to the special deduction rules, the corporation making the contributions is not treated as the owner of part of the trust merely because the trust has or acquires U.S. beneficiaries.

Effective date

The bill would be effective upon enactment.

Revenue effect

The revenue estimate for this bill is not yet available.

2. S. 2805—Senator Nelson

Deferred Application of Revenue Procedure 80–5 and Revenue Ruling 80–60 Relating to Inventory Writedowns

Present law

Background

On February 8, 1980, the Internal Revenue Service issued a news release (Internal Revenue News Release IR–80–19, I.R.B. 1980–6) announcing the publication of Revenue Procedure 80–5 and Revenue Ruling 80–60. Both pronouncements dealt with the Supreme Court decision in *Thor Power Tool Company* v. *Commissioner*, 439 U.S. 522 (1979), and the writedown of excess inventories. The *Thor Power* decision held that a writedown of any item of inventory would be allowed for tax purposes only if it as in accordance with certain procedures set forth in the Treasury regulations. Any other writedowns would not be considered proper and would not be allowed for tax purposes. The IRS pronouncements required full implementation of the *Thor Power* decision for taxpayers with 1979 calendar year-ends.

Thor Power Tool Company manufactured hand held power tools that contained from 50 to 200 parts. The company had a policy of manufacturing all future estimated replacement parts at the same time it manufactured a new product. In this way the company sought to avoid the problem of having to retool at some future date in order to provide replacement parts to its customers. Therefore, the company had more replacement parts on hand than it would need in the immediate future ("excess inventory").

In 1964, Thor Power's new management determined that a large portion of the parts inventory was in excess of any reasonably foreseeable future demand. Therefore, they wrote the inventory down to scrap value for both financial statement purposes and tax purposes. However, the taxpayer did not make any attempt to sell these goods at a reduced price nor to scrap them but instead retained the parts for possible future sale to customers at their original list price.

Under section 471 of the Internal Revenue Code, the taxpayer is required to keep inventories in a manner that conforms as nearly as possible to the best accounting practice in its trade or business and that most clearly reflects its income. Upon audit, the Commissioner conceded that Thor Power's method of accounting for its inventory was in conformity with the best accounting practice in its trade or business because it was standard accounting policy to writedown excess inventories to their net realizable value. However, the Commissioner determined that the writedown did not clearly reflect the taxpayer's income. The Commissioner contended that in order to clearly reflect income for tax purposes the writedown had to conform to the requirements of section 471 regarding market writedowns and that the taxpayer's writedown did not conform to those requirements.

Supplement to the

Description of Miscellaneous Tax Bills

Listed for a Hearing

Before the

Subcommittee on Taxation and
Debt Management Generally

of the

Committee on Finance

on August 4, 1980

S. 2938--Senators Dole, Baucus, Cochran, Ford, Hatch, Mathias, Moynihan, and Wallop

Income Tax Exclusion for Certain Federal Scholarship Grants

The bill, S. 2938, contains provisions which are identical to those contained in section 1 of H.R. 7171 which is scheduled for the public hearing on August 4, 1980.

In addition, S. 2938 would extend the temporary exclusion under present law for one year for National Research Service Awards. As extended, tax-exempt scholarship treatment would apply through calendar year 1981.

The regulations under section 471 allow a taxpayer to writedown its inventory to the lower value of cost or market. In general, the definition of the market price of a product is the bid price in the market place for such a product. In Thor Power's situation, the replacement parts had not diminished in value with respect to their market price but the taxpayer felt that there were so many of these parts that they would not all be sold. Therefore, its writedown did not reflect a lower market value of the individual parts but reflected the fact that Thor Power would not be able to sell all the parts. Such a writedown does not qualify under the regulations as a tax deductible writedown.

In addition to the market price writedown, the regulations provide for two other circumstances where inventory can be written down below its cost. The first is where the taxpayer actually *offers* the property for sale at prices below the current market price of the inventory during the tax year of the writedown. In that case, the taxpayer may value the inventory at the price being offered less the direct costs of disposition. The second situation is in the case of goods that are not saleable at normal prices because of damage, imperfections, shop ware, and other similar infirmities ("subnormal goods"). In the case of such unsaleable goods, the taxpayer may value the inventory at a bona fide selling price less direct costs of disposition. The bona fide selling price is defined as the selling price at which the goods are actually offered for sale during a period ending not later than 30 days after the inventory date (generally the corporation's year-end). In both of these situations, the taxpayer must actually offer the goods for sale.

In *Thor Power*, the taxpayer wrote the inventory down below the market value but did not offer the parts for sale at a reduced price. In fact, the company conceded that it continued to sell these parts at their original list prices. The Supreme Court held that in order for a taxpayer's method of inventory accounting to clearly reflect income, and thus to be an allowable method of inventory accounting under section 471, it must conform to the writedown requirements in the Treasury regulations. Since Thor Power's inventory writedown did not conform to these regulations, it was held to be an improper method of inventory accounting and the deduction for the writedown was denied.

Rules relating to changes in methods of accounting

Under Code section 446, a taxpayer may not change the method in which he accounts for his income unless he secures the consent of the Commissioner. This is to prevent taxpayers who account for their income in one manner from changing to another manner and avoiding tax as a result of the change. For instance, if in year one a cash basis taxpayer sells property for $100 on account, income is not recognized until the $100 is actually received in a subsequent year. If in year two, however, the taxpayer changes to an accrual method of accounting, no income will be recognized for that year because under the accrual method of accounting the year for reognizing the $100 of income is the year in which the account receivable arose, which was year one. In the absence of special rules, this would be the result even though the account receivable is paid in year two because the payment of an account receivable does not give rise to income under the accrual method of accounting. Thus, in this example the taxpayer would avoid entirely the recognition of the $100 of income on the sale.

In order to prevent taxpayers from avoiding tax as a result of changing accounting methods, Code section 446 provides that the taxpayer may not change his method of accounting, even if it is an erroneous method of accounting, without obtaining the permission of the Commissioner. This allows the Commissioner the opportunity to permit the change but only if the taxpayer will make adjustments that will result in the clear reflection of his income. (The amount of the adjustment is actually computed under section 481 and is referred to as the "section 481 adjustment.") However, this procurement has the rather anomalous result of requiring a taxpayer to continue an erroneous method of accounting unless he has secured the consent of the Commissioner to change.

With respect to the *Thor Power* decision, the Internal Revenue Service believed that many taxpayers would not request permission to change the proper method of accounting for excess inventories and, under the requirement that they maintain their method of accounting, they would continue to improperly writedown excess inventories. This not only gave taxpayers the advantage of continuing to write off excess inventories until eventually challenged by the Internal Revenue Service on audit, but it held out the prospect that their erroneous method of inventory accounting might never be discovered by the IRS.

As a response to the possibility that taxpayers would not request permission to change erroneous methods of inventory accounting in accordance with the *Thor Power* decision, the Internal Revenue Service issued Revenue Procedure 80–5 and Revenue Ruling 80–60 on February 8, 1980. Revenue Procedure 80–5 granted blanket permission to all taxpayers that they may change their method of accounting in conformity with the *Thor Power* decision. Revenue Ruling 80–60 presented a fact situation regarding excess inventories and in its conclusion stated that if a taxpayer did not account for its inventory in accordance with the *Thor Power* decision and Revenue Procedure 80–5 that the taxpayer would be filing his tax return "not in accordance with the law." The obvious implication of this last statement is that the taxpayer would be liable for various penalties for failure to file a proper tax return.

Principal taxpayer argument

It is the position of taxpayers that the retroactive application of the two IRS pronouncements (i.e., the pronouncements were issued in 1980 but were to actually take effect in 1979) precludes them from being able to comply in 1979 with certain Treasury regulations that would have mitigated the income recapture required under the *Thor Power* decision. The taxpayers claim that if they had proper notice of the pronouncements in 1979 they would have offered a large part of their excess inventory for sale at reduced prices in 1979. Thus, they would have been in compliance with both the Treasury regulations and the *Thor Power* decision on those inventory writedowns and would not have had to recapture income with respect to that inventory. However, since the goods have to be offered for sale in the taxable year in which the writedown is to be taken, taxpayers claim that issuance of the pronouncements in 1980 prevented them from taking any action in 1979.

Issue

The issue is whether the application of Revenue Ruling 80–5 and Revenue Ruling 80–60 should be delayed from 1979 to 1980.

Explanation of the bill

The bill would delay the effective date of Revenue Procedure 80–5 and Revenue Ruling 80–60 from tax years ending on or after December 25, 1979 to tax years beginning after December 31, 1979.

Effective date

The bill would apply to tax years ending after December 31, 1979.

Revenue effect

It is estimated that this bill will reduce budget receipts by about $25 million in fiscal year 1980 and increase them by the same amount in later years, primarily fiscal year 1990.

3. S. 2818—Senators Talmadge, Baucus, and Pryor

Tax Treatment of Mutual or Cooperative Telephone and Electric Companies

Present law

Rural cooperatives

Under present law (Code sec. 501(c)(12)), a mutual or cooperative telephone company qualifies for exemption from Federal income taxation only if at least 85 percent of its income consists of "amounts collected from members for the sole purpose of meeting losses and expenses." In determining whether this member-income test has been satisfied, amounts of credits accrued or received by a mutual or cooperative telephone company from another company for communications services on calls involving members of the telephone cooperative are not taken into account.

Similarly, a rural electric cooperative may qualify for exemption from Federal income taxation under Code section 501(c)(12) if it satisfies the 85-percent member-income test.[1]

Tax on unrelated business income

Under present law, most organizations which are generally tax exempt under the Internal Revenue Code are nonetheless subject to tax on unrelated business taxable income (Code sec. 511). Thus, unless a specific exception applies, an organization which is tax-exempt (under Code sec. 501(a))[2] 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.

Recently, the Internal Revenue Service has indicated that income from the rental of poles (*e.g.*, payments by rural electric cooperatives for use of a rural telephone cooperative's poles) and display listings in "Yellow Page" directories may be included in nonmember income of rural cooperatives.

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[1] See Rev. Rul. 65–99, 1965–1 C.B. 242; Rev. Rul. 65–174, 1965–2, C.B. 169. In addition, certain rural electric cooperatives in the Tennessee Valley Authority ("TVA") area are exempt from taxation under Code section 501(c)(4) even though, generally because of TVA requirements, they do not meet the 85-percent member-income test. See *U.S.* v. *Pickwick Electric Membership Corp.*, 158 F.2d 272 (6th Cir. 1946).

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

Issues

The issues are whether income from pole rentals and display listings should be treated as nonmember income for purposes of the 85-percent member-income test and whether income from pole rentals should be subject to the tax on unrelated business taxable income.

Explanation of the bill

The bill would provide that, in applying the 85-percent member-income test to a mutual or cooperative telephone company, any income from qualified pole rentals or from display listings in a telephone directory is to be disregarded. Also, in applying the 85-percent nonmember-income test to mutual or cooperative electric companies, any income from qualified pole rentals is to be disregarded. Income from qualified pole rentals generally means any income from the sale of the right to use any pole (or other structure) (1) which is used by the cooperative in providing telephone or electric services to its members, and (2) the use for which the pole is rented involves the transmission by wire of electricity or of telephone or other communications.

The bill also would provide that the engaging in activities which result in the receipt of qualified pole rentals is not an unrelated trade or business for a mutual or cooperative telehpone or electric company. Thus, such rentals would not be subject to the tax on unrelated business taxable income.

Effective date

The amendments relating to the 85-percent member-income test would apply to all taxable years to which the Internal Revenue Code of 1954 applies.

The amendments to be unrelated business income provisions would apply to all taxable years beginning after December 31, 1969 (the general effective date of the provisions of the Tax Reform Act of 1969 which applied the tax on unrelated business taxable income to organizations exempt under Code sec. 501(c)(12)).

Revenue effect

It is estimated that this bill will reduce budget receipts by less than $5 million annually.

4. S. 2904—Senators Talmadge, Glenn, and Dole

Adjustment in Excise Tax on Tires

Present law

Present law (sec. 4071(a) of the Code) imposes a manufacturers excise tax of 10 cents per pound on new tires [1] of the type used on highway vehicles, and 5 cents per pound on new nonhighway tires. The tax on new highway tires is scheduled to be reduced to 5 cents per pound on October 1, 1984 (sec. 4071(d)); the tax on nonhighway tires is to remain at 5 cents per pound. Revenues from the tax on tires go into the Highway Trust Fund (through September 30, 1984).

Since these taxes are imposed on the basis of the weight of the tire, the price for which the tire is sold generally does not affect the amount of tax due on a manufacturer's sale. However, under IRS administrative guidelines (Rev. Rul. 59–394, 1959–2 CB 280), an exception occurs when a tire manufacturer sells a new replacement tire at a reduced price pursuant to a warranty or guarantee on the tire that is being replaced. Then the manufacturers excise tax on the replaced tire is to be reduced in proportion to the reduction in price of the replacement tire. This amount is allowable as a credit or refund (without interest) of the manufacturers excise tax on the replaced tire (sec. 6416(b)).

The tire industry's practice has been to apply this rule based on the proportionate reduction in the price to the ultimate consumer where the warranty or guarantee is invoked by the ultimate consumer. This reduction is often greater than the reduction in the price of the replacement tire to the vendee who provides the replacement tire to the ultimate consumer. However, the Internal Revenue Service has taken the position (Rev. Rul. 76–423, 1976–2 CB 345) that the tax should be reduced in proportion to the reduction in price from the manufacturer to its immediate vendee—usually, a wholesaler or a dealer. Under current warranty or guarantee practices used in the tire industry, the Service's position generally produces a smaller tax reduction (hence, a larger net tax) than that produced by a rule that is based on the adjustment in the sale price to the ultimate consumer.

Revenue Ruling 76–423 also provides similar rules for the situation where the manufacturer's warranty or guarantee runs to the dealer but not to the ultimate consumer, and where the replacement tire is not from the same manufacturer as the original tire being returned under the warranty or guarantee. Finally, the ruling provides that,

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[1] The tax applies on the sale (sec. 4071(a)(1) and (2)) or delivery to a retail outlet (sec. 4071(b)) of a manufacturer, producer or importer. (A lease (sec 4217) or use (sec. 4218) is treated as a sale for these purposes.) In general, this means that, as to domestically manufactured tires, the tax applies to new tires and also to tires that have been retreaded "from bead to bead" (thereby making them new articles). As to imported tires, the tax applies whether or not the tire is new, if the tire has not previously been taxed in the United States. Tires on imported articles (other than articles taxed under sec. 4061 as trucks, etc.) also are subject to tax.

where the manufacturer initially sells tires to a dealer "under a price reduction arrangement in lieu of a warranty," no adjustment in excise tax is allowable.

As originally announced, the 1976 ruling was to have taken effect with respect to this issue on April 1, 1977. After having been twice postponed by the Service, the effective date of the 1976 ruling became April 1, 1978.

Issues

The principal issue is whether the current system of excise taxes on tires should be replaced with a system under which lower tax rates would apply to new tires and no credit or refund would be allowed with respect to tires for which a warranty or guarantee adjustment is made. Such a system could be designed in a manner that would have no significant effect on the overall receipts from the excise taxes on tires.

Another issue is whether, for periods for which credits or refunds are allowed, excise tax credits or refunds should be determined under the tire industry's prior practices or under the rules prescribed in Rev. Rul. 76-423.

Explanation of the bill

The bill would reduce the rate of manufacturers excise tax on new tires by 2.5 percent, beginning on January 1, 1981. Thus, the tax on new highway tires would be reduced to 9.75 cents per pound on January 1, 1981, and to 4.875 cents per pound on October 1, 1984; and the tax on new nonhighway tires would be reduced to 4.875 cents per pound on January 1, 1981.

The bill also would provide a special rule for the determination of an excise tax credit or refund with respect to tires for which a warranty or guarantee adjustment is made. For the adjustment of any tire after March 31, 1978, and prior to January 1, 1983, a credit or refund would be determined under the practice used by the industry prior to the effective date of Rev. Rul. 76-423. No credit or refund would be allowed for a warranty or guarantee adjustment of any tire after December 31, 1982.

Effective date

The amendments relating to excise tax rates would apply for new tires sold after December 31, 1980.

The provisions relating to the determination of an excise tax credit or refund would apply to the adjustment of any tire after March 31, 1978, and prior to January 1, 1983.

The amendments relating to disallowance of an excise tax credit or refund would apply to the adjustment of any tire after December 31, 1982.

Revenue effect

Because it would reduce excise tax rates on new tires for two years before it would first disallow credits or refunds, it is estimated that the bill would decrease net excise tax receipts (receipts less credits and refunds) by $15 million in fiscal year 1981, by $20 million in fiscal year 1982, and by $5 million in fiscal year 1983. The bill would have negligible effects on net receipts after fiscal year 1983.

B. CERTAIN SECTIONS OF HOUSE-PASSED BILL, H.R. 7171

1. Income Tax Exclusion for Certain Federal Scholarship Grants (Sec. 1 of the 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 excludable 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)).

Certain Federal scholarship programs require, as a condition of their award, performance of future service for the Federal Government. The Internal Revenue Service has ruled that awards under these programs would not be excludable from gross income under the general scholarship provision (Rev. Rul. 76–99, 1976–1 C.B. 40). However, special temporary legislation provides that recipients of Armed Forces Health Professions scholarships, Public Health Service scholarships, and similar programs may exclude from gross income amounts received as scholarships under these programs. 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.)

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 provision

This section of H.R. 7171 would provide that an amount, which is received by an individual as a grant under a Federal program [1] and which would be excludable from gross income as a scholarship or fellowship grant, but for the fact that the recipient must perform future

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[1] The House Committee on Ways and Means understood that this provision will not affect the treatment of payments to cadets and midshipmen at the United States military academies. An appointee to a military academy is considered a member of the regular military service. See Rev. Rul. 55–347, 1955–1 C.B. 21. Thus, the taxability of payments made to cadets and midshipmen is governed by provisions other than the scholarship provision.

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 excludable qualified tuition and related expenses are amounts 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 provision defines 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.

The tax treatment of scholarships and fellowships, other than those specifically covered by the bill, would remain governed by the present law rules under Code section 117.

Effective date

The provision would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision would reduce budget receipts by $3 million in fiscal year 1981, $8 million in fiscal year 1982, $14 million in fiscal year 1983, $20 million in fiscal year 1984, and $24 million in fiscal year 1985.

2. Tax Treatment for Members of an Affiliated Group Which Included a Transferor Railroad in the ConRail Reorganization (Secs. 4 and 5 of the 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 ConRail was treated like reorganizations in general (and other bankrupt railroad reorganizations in particular) so that the transferor companies and their shareholders and security holders did not recognize gain or loss on the transfer and ConRail received a carryover basis in the properties it acquired (Code sec. 374(c)). In addition, where the carryover period has expired for a transferor railroad's net operating losses which were incurred before and during the taxable year in which the ConRail reorganization took place, these losses generally may be revived to apply against any income eventually recognized from the ConRail transfer (Code sec. 374(e)).

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

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[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.

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 investment in the stock of the loss corporation is reduced, generally by an allocated portion (based on stock ownership) of the losses reflected in the consolidated return. If the losses used on the consolidated returns exceed the basis of the stock owned by the 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 for an affiliated group cease to be 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 of the loss affiliate's stock. In these situations, ordinary income will result to the extent of "insolvency" of the loss affiliated and special rules are provided for determining insolvency in situations concerning excess loss accounts. Where an excess loss account is restored, a previously used net operating loss in not restored to the loss affiliate.

Issues

The first 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.

The second issue is whether net operating losses of a transferror railroad should be restored to be used to offset income eventually recognized as a result of the ConRail transfer if the affiliated group, of which the transferor railroad had been a member, restores to income the excess loss account arising from the use of the net operating losses on a consolidated return for the affiliated group.

Explanation of provisions

Consolidated return regulations (*sec. 4 of the bill*)

Section 4 of 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 deter-

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[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.

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

mination of value by the special court becomes final. Under this rule, where the question of whether there have been certain types of dispositions (called "deemed dispositions") of a ConRail transferor railroad's stock under the consolidated return regulations depends upon the determination of value by the special court, a deemed disposition will not be considered as occurring until the earlier of either the date the special court's determination becomes final or the occurrence of another event which causes restoration of the excess loss account under the consolidated return regulations. The specific types of deemed dispositions which are addressed by this provision are: (1) worthlessness of the stock of the transferor railroad and, (2) where 10 percent or less of the face amount of an obligation of the transferor railroad will be recoverable at maturity by its creditors, as these two types of deemed dispositions are described in Income Tax Regulations § 1.1502–19(b) (2) (iii) and (iv), respectively. As a result, the excess loss account will be restored before the special court's determination becomes final if, for example, the transferor railroad ceases to be a member of the affiliated group, or if another member of the affiliated group transfers an obligation of the transferor railroad to a nonmember of the group for 25 percent or less of its face value.

Section 4 of the bill is intended to benefit the Norfolk and Western Railway Company.

Net operating losses (sec. 5 of the bill)

Under section 5 of the bill, it is provided that if an excess loss account arising from the net operating losses of a transferor railroad is restored to income of the affiliated group which filed consolidated income tax returns with the transferor railroad, these losses which are subject to the revival provisions generally under the ConRail reorganization will be restored to the transferor railroad in an amount which corresponds to the ordinary income (or its equivalent in capital gain income adjusted to reflect the lower capital gains rate) recognized by the affiliated group through triggering the excess loss account. Because existing law concerning the revival of net operating losses by ConRail transferor railroads applies only to those losses incurred before or during the taxable year which includes the April 1, 1976, ConRail transfer, the net operating losses which are eligible for restoration to the transferor railroad under this provision are limited to those of the transferor railroad which contributed to the excess loss account and which are incurred either in the first taxable year which ends after March 31, 1976, or in a prior taxable year, and which could be carried over to the first taxable year which ends after March 31, 1976.

A first-in-first-out rule is also provided for purposes of this provision so that the restoration of the excess loss account will be considered, for purposes of restoring net operating losses to the transferor railroad under this provision, to result from the earliest of the losses which created the excess loss account. The net operating losses which are restored may only be applied against income which is eventually recognized from the March 31, 1976, transfer to ConRail. In addition, where losses eligible for restoration to the transferor railroad are attributable to capital gain income recognized by other members of the affiliated group (through restoration of the excess loss accounts) these losses will be restored to the transferor railroad only in amounts equal to the ordinary income equivalent of these capital gains. The ordinary income equivalent of the capital gain is the capital gain multiplied by a fraction, the numerator of which is the capital gain tax rate of corporations for the taxable year in which the excess loss accounts were restored, and the denominator of which is the maximum rate of tax on ordinary income of corporations for this taxable year.

The provisions of section 5 of the bill can be illustrated by the following example. Assume that the basis of a transferor railroad's stock owned by the other members of the affiliated group had been reduced to zero at the end of 1974, because of prior losses used by the group, that the transferor railroad incurred net operating losses of $10 million in calendar year 1975, $20 million in 1976, and $15 million in 1977, and that in 1978 it had $10 million of income. Assume further that in 1979 the transferor railroad ceased to be a member of the affiliated group, and the excess loss accounts of the other members of the group, $35 million in total, are restored as ordinary income to the group. Because of the ordering rule in the bill, the $10 million of the transferor railroad's income in 1978 is deemed to offset its post–1976 loss. Accordingly, the full $30 million of losses which were incurred in 1975 and 1976 (and which increased the excess loss account) will be restored under the rules of the bill. In addition, if the transferor railroad is insolvent to the extent of $20 million at the time of the restoration of the excess loss accounts, the amount of the restoration of losses to the transferor would be $20 million plus 28/46 times $10 million, or a total of $26,086,956. This reflects the second aspect of the ordering rule, which attributes the ordinary income portion of the restoration to the earliest losses of the transferor railroad.

Section 5 of the bill is intended to benefit the Erie Lackawanna Railway Company, a member of the affiliated group of corporations of which the Norfolk and Western Railway Corporation is the present corporation.

Effective date

The provisions apply to deemed dispositions of a ConRail transferor's stock for taxable years ending after March 31, 1976, and to restorations after March 31, 1976, of excess loss accounts attributable to net operating losses of a ConRail transferor.

Revenue effect

The revenue effects of sections 4 and 5 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 Norfolk and Western Railway Company 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 or the Erie Lackawanna Railway Company ceased to be a member of the affiliated group of corporations of which the taxpayer is the parent corporation.

Restoration of the net operating losses to the Erie Lackawanna Railway Company could eventually decrease budget receipts by some amount of less than $15 million. However, these potential revenue losses are not expected to take place before fiscal year 1986.

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