[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS
(S. 146, S. 1332, S. 1768, S. 1809, and S. 2080)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on March 16, 1984, before the Senate Finance Subcommittee on Taxation and Debt Management.

The five bills scheduled for the hearing are S. 146 (permanent exemption from FUTA tax for wages of certain fishing boat crew members); S. 1332 (relating to investment tax credit for certain vessels acquired with funds withdrawn from a capital construction fund); S. 1768 (energy tax credit for certain fishing vessel equipment); S. 1809 (exception for regulated investment companies from definition of personal holding company); and S. 2080 (permanent exclusion for benefits under group legal services plans).

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

I. SUMMARY

1. S. 146—Senators Mitchell, Cohen, Mathias, Heflin, and Sarbanes

Permanent Exemption from FUTA Tax for Wages of Certain Fishing Boat Crew Members

Prior to the Economic Recovery Tax Act of 1981, the remuneration paid to fishing boat crew members who were considered self-employed for social security tax purposes, and whose remuneration was exempt for purposes of the tax imposed by the Federal Insurance Contributions Act (FICA) and for purposes of income tax withholding, was not exempt from tax under the Federal Unemployment Tax Act (FUTA) if the services performed were related to catching halibut or salmon for commercial purposes or if the services were performed on a vessel of more than ten net tons.

The Economic Recovery Tax Act of 1981, as amended by the Miscellaneous Revenue Act of 1982, amended the definition of employment for purposes of FUTA taxes to exempt from FUTA taxes remuneration paid during 1981 and 1982 to fishing boat crew members who were treated as self-employed for purposes of social security taxes.

The bill would have the effect of making permanent this exemption from FUTA taxes for taxable years beginning after 1982.

2. S. 1332—Senator Mitchell

Investment Tax Credit for Certain Vessels Acquired With Funds Withdrawn from a Capital Construction Fund

Present law provides that taxable income is reduced by amounts equal to certain amounts deposited in a capital construction fund established under section 21 of the Merchant Marine Act of 1970 (46 U.S.C. 1177(d)). When withdrawn from the fund, such amounts are generally taxable unless used to acquire, construct, or reconstruct a qualified vessel. If used to acquire, construct, or reconstruct a qualified vessel, such amounts are not taxable; however, the taxpayer's basis in the vessel is reduced to reflect the fact that the taxpayer had previously deducted those amounts.

Present law also generally provides that the amount of investment tax credit allowable with respect to new property eligible for the credit is determined with reference to the basis in such property. For investment credit purposes, the basis of a qualified vessel financed in whole or in part with previously deducted funds withdrawn from a capital construction fund is not to be reduced by more than 50 percent of the amount of previously deducted funds so withdrawn (Code sec. 46(g)).

The bill would provide that for investment credit purposes, the basis of a qualified vessel financed in whole or in part with previously deducted funds withdrawn from a capital construction fund is not to be reduced by any portion of the previously deducted funds so withdrawn. Thus, no investment credit otherwise available would be lost. The bill would be effective for taxable years beginning after 1982.[1]

3. S. 1768—Senator Mitchell

Energy Tax Credit for Certain Fishing Vessel Equipment

In general, the 10-percent business energy investment tax credit expired after 1982. However, the general 10-percent energy credit for certain types of long-term energy projects continues through 1990 if certain affirmative commitments were made in connection with the projects. Also, certain business energy credits (other than the general 10-percent energy credit), such as the 15-percent credit for solar, wind, or geothermal property and the 10-percent credit for biomass property, continue through 1985.

Under the bill, a 10-percent energy tax credit would be provided for 11 specified items of equipment used aboard or installed in fishing vessels. The credit would apply for equipment placed in service in 1983, 1984, and 1985.

4. S. 1809—Senator Baucus

Exception for Regulated Investment Companies from Definition of Personal Holding Company

Under present law, a corporation is treated as a personal holding company if, among other requirements, at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for no more than five individuals (Code secs. 541-547). For this purpose, an individual is considered as owning the stock owned, directly or indirectly, by or for members of his or her family, or by or for a partner of the individual. A personal holding company cannot qualify as a regulated investment company.

Under the bill, an investment company would not be treated as a personal holding company if certain stock ownership tests are met. Further, for purposes of applying such tests, stock owned, directly or indirectly, by or for an individual would not be attributed to such individual's partners in a limited partnership. The amendments made by the bill would apply to taxable years ending on or after the date of enactment.

5. S. 2080—Senators Packwood, Moynihan, and Stevens

Permanent Exclusion for Benefits Under Group Legal Services Plans

Under present law, amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses

[1] It is understood that this date would be changed to December 31, 1983.

or dependents) are excluded from an employee's gross income for income tax purposes (Code sec. 120) and from wages for employment tax purposes (secs. 3121(a)(17), 3306(b)(12)). Present law also provides that an organization created exclusively to form part of a qualified group legal services plan may be exempt from income tax (sec. 501(c)(20)). The exclusion for prepaid legal services and the tax exemption for group legal services organizations are scheduled to expire for taxable years beginning after December 31, 1984.

The bill would make permanent the exclusion from gross income for payments to or under a qualified group legal services plan and the tax-exempt status of group legal services organizations. The bill would be effective on the date of enactment.

II. DESCRIPTION OF THE BILLS

1. S. 146—Senators Mitchell, Cohen, Mathias, Heflin, and Sarbanes

Permanent Exemption from FUTA for Wages of Certain Fishing Boat Crew Members

Present Law

For purposes of social security taxes and income tax withholding, members of the crew on a boat in a fishing operation engaged in catching fish or other forms of aquatic animal life are considered to be self-employed if (1) their remuneration is a share of the boat's catch (or cash proceeds from the sale of a share of the catch and no other cash remuneration is provided), (2) their share depends on the amount of the boat's catch, and (3) if the crew of the boat normally is made up of fewer than ten individuals. If these requirements are met, remuneration paid to these crew members is exempt from the Federal Insurance Contributions Act (FICA) tax and income tax withholding, and is subject to the Self-Employment Contributions Act (SECA) tax (Code secs. 3121(b)(20), 3401(a)(17), and 1402(c)(2)(F)).

Prior to the Economic Recovery Tax Act of 1981 (ERTA), remuneration paid to fishing boat crew members was not exempt from tax under the Federal Unemployment Tax Act (FUTA) if the services performed were related to catching halibut or salmon for commercial purposes or if the services were performed on a vessel of more than ten net tons (sec. 3306(c)(17)).

Section 822 of ERTA amended the definition of employment for purposes of FUTA taxes to exempt from FUTA taxes remuneration paid during 1981 to fishing boat crew members who were treated as self-employed for social security tax purposes and thus exempt from FICA. The exemption from FUTA taxes was limited to 1981 to give the Congress an opportunity (1) to determine the best long-term solution to the problem of fishing boat crew members who are treated as self-employed for purposes of social security and income tax withholding, but who are not treated as self-employed for purposes of the unemployment tax provisions, and (2) to make certain that no fishing boat crew members would be adversely affected. Section 203 of the Miscellaneous Revenue Act of 1982 (P.L. 97-362) amended ERTA to provide that the exemption from FUTA taxes was effective for remuneration paid in 1981 and 1982.

Explanation of the Bill

The bill would provide that, notwithstanding any other provisions of law, the definition of employment and the exclusions from that definition for purposes of FUTA, as amended by section 822 of

ERTA and section 203 of the Miscellaneous Revenue Act of 1982, are effective with respect to taxable years beginning after 1982. Thus, the bill would make permanent the present FUTA tax exemption for remuneration paid to fishing boat crew members who are treated as self-employed and are exempt from FICA.

Effective Date

The bill would be effective upon enactment.

2. S. 1332—Senator Mitchell

Investment Tax Credit for Certain Vessels Acquired With Funds Withdrawn from a Capital Construction Fund

Present Law

The Merchant Marine Act of 1970

The Merchant Marine Act of 1970, as amended (the "Act"), provides certain Federal income tax incentives for U.S. taxpayers owning or leasing vessels operating in the foreign or domestic commerce of the U.S. or in U.S. fisheries (46 U.S.C. sec. 1177(d)).

In general, such taxpayers are entitled to deduct from income certain amounts deposited in a capital construction fund pursuant to an agreement with the Secretary of Transportation or, in the case of U.S. fisheries, the Secretary of Commerce. Furthermore, earnings from the investment or reinvestment of amounts in such a fund are excluded from income. The purpose of the Act is to provide a tax inducement to aid the U.S. shipping and shipbuilding industries.

A nonqualified withdrawal of previously deducted or excluded monies by a taxpayer from a fund will generate income to the taxpayer. However, a qualified withdrawal will not. A qualified withdrawal is a withdrawal, made in accordance with the terms of the applicable agreement, which is for the acquisition, construction, or reconstruction of a qualified vessel or for the payment of principal on indebtedness incurred in connection with the acquisition, construction, or reconstruction of such a vessel. A qualified vessel is a vessel (including barges and containers which are part of the complement therefor) constructed or reconstructed in the U.S. and documented under U.S. laws which is to be operated in the U.S. foreign, Great Lakes, or noncontiguous domestic trade or in U.S. fisheries.

Cost recovery

Since the Act provides for the deduction (or exclusion) of certain amounts deposited in a capital construction fund and their tax-free withdrawal in the case of a qualified withdrawal, the Act also requires a reduction in the tax basis of the qualified vessel in an amount based on the amount of funds withdrawn. Without that rule, a taxpayer would be entitled to cost recovery deductions with respect to amounts the taxpayer had already deducted from (or never included in) income. The purpose of that rule, then, is to prevent double deductions.

Investment tax credit

In general, the amount of investment tax credit for eligible new property (new section 38 property) is determined with reference to

the basis of such property to the taxpayer (Code sec. 46(c)(1)(A)). Under Treasury regulations, if the basis of new section 38 property is reduced, for example, as a result of a refund of part of the cost of the property, then investment credit is recaptured (Treas. Reg. sec. 1.47-2(a)(1)).

Prior to 1976, the law made no explicit provision for the effect of the Act's basis reduction rules on the amount of investment credit to be allowed with respect to a qualified vessel constituting new section 38 property which was financed in whole or in part by qualified withdrawals from a capital construction fund. The Internal Revenue Service has ruled that the investment credit should be determined with reference to the property's basis after the reduction required by the Act (Rev. Rul. 67-395, 1967-2 C.B. 11).

Two courts have addressed the issue. The U.S. Tax Court has agreed with the Internal Revenue Service (*Zuanich* v. *Comm'r,* 77 T.C. 428 (1981)). However, the U.S. Court of Claims (now the Claims Court) has disagreed, holding on several occasions that the fact that the cost of a qualified vessel was financed in whole or in part by previously deducted or excluded funds withdrawn from a capital construction fund has no effect on the investment credit to be allowed (see, e.g., *Oglebay Norton Co.* v. *U.S.,* 79-2 USTC para. 9705 (1979); and *Pacific Far East Line, Inc.* v. *U.S.,* 76-2 USTC para. 9718 (1976)). Based on the foregoing, taxpayers facing the issue generally seek to litigate it in the Claims Court.

The Internal Revenue Service has also ruled that a qualified withdrawal of previously deducted or excluded funds used to pay a principal amount on mortgage indebtedness incurred to purchase a qualified vessel should be treated as reducing basis for investment credit purposes and triggering investment credit recapture under Treas. Reg. sec. 1.47-2(a)(1) (see, e.g., Rev. Rul. 68-468, 1968-2 C.B. 26).

The Tax Reform Act of 1976 provided, only for purposes of determining the investment credit, that basis is to be reduced by not more than 50 percent of the amount of a qualified withdrawal of previously deducted or excluded funds (sec. 46(g)). That rule was made applicable with respect to investment credits claimed in years beginning after 1975. However, section 46(g)(3) and its legislative history make it clear that the new rule established only a floor for, and not a ceiling on, the amount of basis which a qualified vessel would be treated as having for investment credit purposes. In other words, after the Tax Reform Act of 1976, a taxpayer could seek to establish that no investment credit should be lost merely because a qualified withdrawal of previously deducted or excluded funds had been used in financing the acquisition, construction, or reconstruction of a qualified vessel (see *Zuanich* v. *Comm'r, supra*).

The Tax Equity and Fiscal Responsibility Act of 1982 generally provided that for cost recovery purposes, the basis of property is to be reduced by 50 percent of any investment credit allowed (sec. 48(q)). An election to reduce allowable investment credit in lieu of reducing basis for cost recovery purposes is available. Present law is not explicit as to how this basis reduction rule applies in a case where a qualified vessel is financed by means of a qualified withdrawal of previously deducted or excluded funds, particularly if the vessel is financed entirely by means of such a withdrawal. In the

latter case, the vessel would have no basis for cost recovery purposes to reduce.

Issues

The cost recovery and investment tax credit rules enacted in the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982 together provide tax benefits for investments in equity-financed depreciable personal property approximately the equivalent of current expensing of the cost of that property. Those rules include provisions which require that a taxpayer elect either to reduce the basis of property for cost recovery purposes by one-half the amount of investment credit taken or reduce the investment credit with respect to such property (sec. 48(q)).

Disregarding investment credits, the present-law rules applicable to certain deposits into a capital construction fund provide tax benefits in excess of those which would be allowed under a system permitting current expensing of that portion of the cost of a qualified vessel financed by means of a qualified withdrawal. That result occurs because funds ultimately to be used in acquiring, constructing, or reconstructing a qualified vessel, a depreciable asset, are deductible (or excludable) before the vessel is placed in service, perhaps even before any contract to acquire, construct, or reconstruct such a vessel is entered into. To the extent any investment credit is allowed with respect to a qualified withdrawal of previously deducted or excluded funds, the tax benefits increase. Finally, to the extent a full investment credit is allowed without any adjustment in basis for cost recovery purposes of the type provided for by section 48(q), the available tax benefits continue to improve.

On the other hand, the Congress over the years has evidenced a policy of providing tax incentives to the domestic shipping and shipbuilding industries. The Merchant Marine Acts and section 46(g) of the Tax Reform Act of 1976 illustrate the point. The bill would provide further support for those industries by codifying the line of cases from the Court of Claims permitting a full investment credit.

The principal issues are whether tax incentives for the domestic shipping and shipbuilding industries should be statutorily increased and, if so, by what amount.

Explanation of the Bill

Initial financing

The bill would provide that no investment credit with respect to a qualified vessel is to be unavailable merely because all or part of the cost of the acquisition, construction, or reconstruction of such a vessel is financed by any deposit in or qualified withdrawal of previously deducted or excluded amounts from a capital construction fund under the Act (sec. 46(g)). Thus, the bill would overturn the holdings in Rev. Rul. 67-395 and *Zuanich* v. *Comm'r, supra*. The bill would make no special provision for adjusting basis for cost recovery purposes.

Payment of principal amount on mortgage indebtedness

The bill would also provide that using funds received in a qualified withdrawal of previously deducted or excluded amounts to pay down principal on indebtedness secured by a mortgage on a qualified vessel is not to give rise to any investment credit recapture.[1] Thus, the bill would also overturn the ruling in Rev. Rul. 68-468, *supra*.

Effective Date

The bill would be effective for taxable years beginning after December 31, 1982,[2] and to investment credits allowed for such taxable years.

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[1] Technical corrections would be needed to the references in the bill to section 167 and to actual useful life.

[2] It is understood that this date would be changed to December 31, 1983.

3. S. 1768—Senator Mitchell

Energy Tax Credit for Certain Fishing Vessel Equipment

Present Law

General rules

Prior to 1983, the law provided a general 10-percent investment credit for certain energy property (in addition to the regular investment credit). Property eligible for the general 10-percent energy credit included alternative energy property (e.g., solar, wind, or geothermal property), specially defined energy property, recycling equipment, shale oil equipment, equipment for producing natural gas from geopressured brine, and cogeneration equipment. The general energy credit for these types of property terminated after 1982, except that the credit is allowed through 1990 for long-term projects for which certain affirmative commitments (described below) were made.

A 15-percent energy credit is allowed through 1985 for solar, wind, geothermal, and ocean thermal property. Qualified intercity buses and biomass property are eligible for a 10-percent energy credit. For periods beginning on January 1, 1982 and ending on December 31, 1982, a 10-percent energy credit was allowed for chlor-alkali electrolytic cells. No affirmative commitment rule applies to these properties.

Qualified hydroelectric generating property is eligible for an 11-percent credit through 1985. The credit for hydroelectric property is allowed through 1988 under a special affirmative commitment rule.

Application of the regular investment credit

If energy property qualifies for the regular investment credit, both the regular and energy credits apply. In general, property eligible for the regular investment credit is tangible personal property, excluding buildings and their structural components, that is depreciable. Thus, for example, solar, wind, or energy air or water heating or cooling systems (which are structural components of buildings) do not qualify for the regular investment credit under present law although they do qualify for energy credits. However, in the case of qualified hydroelectric generating property that is a fish passageway, the regular investment credit, as well as the energy credit, is allowed for any period after 1979, without regard to whether such property otherwise qualifies for the regular investment credit.

Explanation of the Bill

The bill would provide a 10-percent energy investment tax credit for investments in "qualified harvesting vessel equipment" for 1983, 1984, and 1985. The bill defines qualified harvesting vessel equipment as any of 11 specified items used aboard or installed in a vessel (i.e., a ship or barge) engaged in the harvesting of marine resources (i.e., fish and seafood) if the equipment reduces oil, diesel fuel or gasoline consumption. Under the investment credit rules, the equipment would qualify only if used on, or installed in, a vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States.

The 11 specified items are (1) a fuel flow meter, or fuel management digital microprocessor, (2) a hull speed meter, (3) a propeller thrust nozzle, (4) a variable pitch or two-speed propeller, (5) a large-bladed propeller, (6) a bow or side thruster, (7) a hull treatment, (8) a bulbous bow, (9) an on-board heat exchanger, (10) auxiliary sale equipment, and (11) automatic Loran C navigational apparatus.

Generally, a fuel flow meter or a fuel management digital microprocessor provides contemporaneous data on the rate of fuel usage in terms of gallons of fuel consumed per hour of running time. This information may help a captain identify when either poor sailing practices or poor maintenance are retarding the ship's performance. A hull speed meter acts in a manner similar to a speedometer except that speed is measured relative to the water rather than fixed geography. Since speed is difficult to judge accurately at sea (because fixed reference points are not readily available), a hull speed meter enables a captain to operate the ship's engines in their more efficient range.

A propeller thrust nozzle is a device which directs the exhaust of a ship's engines at the hub of the propeller. Thus, the exhaust is made to assist the motion of the ship. A variable pitch or two-speed propeller is one which enables the captain to, in effect, shift gears in the same manner that feathering the props on an aircraft changes the work load. A large- bladed propeller effectively allows a ship to develop forward motion at low engine speeds. Use of a large-bladed propeller is similar to installation of a transmission with lower than usual gears in a truck.

Bow and hull thrusters are water jets that assist in turning the vessel. The ability to turn rapidly would reduce the overall distance traveled (and thus the fuel consumed) by a vessel.

A hull treatment would be an antifouling paint or other treatment which prevents the buildup of seaweed or barnacles. Such buildups would cause a drag on the hull and thus increase energy consumption.

A bulbous bow increases the efficiency of a vessel by reducing the drag caused by turbulence.

On-board heat exchangers may be used to warm heavy fuel oil to make it more fluid before burning or to chill engine coolant. Both processes would increase energy efficiency.

An auxiliary sail may be used to augment, or substitute for, power from the fuel-burning engines.

An automatic Loran C navigational apparatus uses Coast Guard broadcast information to chart the ship's position. Use of a Loran

system reduces risks from navigational errors and may reduce fuel consumption by permitting ships to follow more direct courses.

Effective Date

The bill would apply for property placed in service in 1983, 1984, and 1985.

4. S. 1809—Senator Baucus

Exception for Regulated Investment Companies From Definition of Personal Holding Company

Present Law

Under present law, a 50-percent tax is imposed each year on the undistributed personal holding company income of a personal holding company (Code secs. 541-547). A corporation is treated as a personal holding company if (1) at least 60 percent of its adjusted ordinary gross income for the taxable year consists of personal holding company income (i.e., certain dividends, interest, rents, and royalties, as defined in the Code), and (2) at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. For this purpose, an individual is considered as owning the stock owned, directly or indirectly, by or for members of his or her family, or by or for a partner of the individual.

Under present law, certain corporations are excepted from the definition of personal holding companies. The excepted corporations include tax-exempt organizations, banks, domestic building and loan associations, life insurance companies, surety companies, foreign personal holding companies, lending or finance companies meeting certain active business and gross income tests, foreign corporations with no domestic shareholders, small business investment companies licensed by the Small Business Administration, and corporations subject to the jurisdiction of a bankruptcy court.

A regulated investment company ("RIC"), generally speaking, is a domestic corporation (other than a personal holding company) that issues shares to investors and invests the proceeds in securities. Regulated investment companies are generally treated as conduits for Federal income tax purposes (secs. 851-855).

Explanation of the Bill

Because of the attribution rule described above, under present law an investment company may be treated as a personal holding company, and fail to qualify as a RIC, if the shareholders of the investment company own limited partnership interests in the same partnership. Under the bill, a RIC would not be treated as a personal holding company if, at all times during the second half of the taxable year, (1) the company has at least 100 shareholders that are individuals or are treated as individuals, and (2) not more than 50 percent in value of the company's outstanding stock is owned, directly or indirectly, by or for five or less individuals. Further, for purposes of the rule attributing to an individual stock owned, directly or indirectly, by or for a partner of the individual, the term partner would not include any limited partners.

Effective Date

The amendments made by the bill would apply with respect to taxable years ending on or after the date of enactment.

5. S. 2080—Senators Packwood, Moynihan, and Stevens

Permanent Exclusion for Benefits Under Group Legal Services Plans

Present Law

In general

Under present law, amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses or dependents) are excluded from an employee's gross income for income tax purposes (Code sec. 120) and from wages for employment tax purposes (secs. 3121(a)(17), 3306(b)(12)). The exclusion also applies to any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for legal services for the employee (or the employee's spouse or dependents).

In order to be a qualified plan under which employees are entitled to tax-free benefits, a group legal services plan must fulfill several requirements with regard to its provisions, the employer, and the covered employees.

Legal services

A qualified group legal services plan must be a separate written plan of an employer for the exclusive benefit of employees or their spouses or dependents. The plan must supply the employees, their spouses, and dependents with specified benefits consisting of personal (i.e., nonbusiness) legal services through prepayment of, or provision in advance for, all or part of the legal fees of an employee or an employee's spouse or dependent.

Present law also provides that amounts contributed by employers under a qualified group legal services plan may be paid only (1) to insurance companies or to organizations or persons that provide personal legal services or indemnification against the cost of personal legal services, in exchange for a prepayment or a payment of a premium; (2) to organizations exempt from taxation as organizations described in section 501(c)(20) (see below for description); (3) to organizations described in section 501(c) that are permitted to receive employer contributions for one or more qualified group legal services plans, provided the organizations pay or credit the employer contributions to another organization that is described in section 501(c)(20); (4) as prepayments to providers of legal services under the plan; or (5) to a combination of the four permissible types of payment arrangements.

Nondiscrimination

In order to be a qualified plan, a group legal services plan must also meet requirements with respect to nondiscrimination in contributions or benefits and in eligibility for enrollment.

Present law requires that the contributions paid by an employer and the benefits provided under a plan may not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated. The plan must benefit employees who qualify under a classification that the employer sets up and that the Internal Revenue Service determines does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated. However, in determining whether a classification is discriminatory, the employer may exclude from the calculations those employees who are members of a collective bargaining unit if there is evidence that group legal services plan benefits were the subject of good faith bargaining between representatives of that group and the employer.

A limit is placed on the proportion of the amounts contributed under the plan that can be applied for employees who own more than five percent of the stock or of the capital or profits interest in the employer corporation or unincorporated trade or business. The aggregate of the contributions for those employees and their spouses and dependents must not be more than 25 percent of the total contributions.

Other rules

Under present law, in order to be treated as a qualified group legal services plan, the plan must notify the Internal Revenue Service that it is applying for recognition of qualified status. If the plan fails to notify the IRS by the time prescribed in Treasury regulations, then the plan is not regarded as a qualified plan for any period before it in fact gave notice.

A self-employed individual who qualifies as an employee within the definition of Code section 401(c)(1) is also an employee for purposes of these group legal services provisions. This means that, in general, the term self-employed individual means, and the term employee includes, individuals who have earned income for a taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for a taxable year. An individual who owns the entire interest in an unincorporated trade or business is treated as his or her own employer. A partnership is considered the employer of each partner who is also an employee of the partnership.

Group legal services organization

Present law also provides that an organization or trust created or organized in the United States whose exclusive function is to form part of a qualified group legal services plan under section 120 is exempt from income tax (sec. 501(c)(20)). Such a trust is subject to the rules generally governing organizations exempt under section 501(c), including the taxation of any unrelated business income. An exempt organization or trust that receives employer contributions for a group legal services plan is not prevented from qualifying for exemption under section 501(c)(20) merely because it provides legal services or indemnification for legal services unassociated with a qualified group legal services plan.

Termination

The present-law exclusion for prepaid legal services and the tax exemption for group legal services organizations are scheduled to expire for taxable years beginning after December 31, 1984.

Explanation of the Bill

The bill would make permanent the exclusion from gross income for payments to or under a qualified group legal services plan and the tax-exempt status of group legal services organizations.

Effective Date

The bill would be effective on the date of enactment.

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