Joint Committee on Taxation
JCX-35-83
November 1, 1983

SUMMARY OF THE REVENUE PROVISIONS OF THE SENATE FINANCE COMMITTEE'S RECONCILIATION RECOMMENDATIONS

Estimated Tax Payments of Alternative Minimum Tax

Under present law, individuals generally are required to make estimated tax payments (including withholding payments) equal to 80 percent of the current year's income tax. Estimated tax payments of the alternative minimum tax are not required.

The bill requires individuals to make estimated tax payments of the alternative minimum tax, effective for taxable years beginning after December 31, 1983.

Modification of Income Growth Threshold for Income Averaging

Under present law, if an eligible individual has current year taxable income exceeding 120 percent of average taxable income in the previous 4 years (averageable income), then the individual may be eligible for income averaging. Under income averaging, the tax liability attributable to averageable income is computed by using only the marginal rates applicable to the first 20 percent of averageable income.

The bill modifies the definition of averageable income to be the amount by which current year taxable income exceeds 140 percent, instead of 120 percent, of average taxable income in the previous 4 years.

Postponement of Net Interest Exclusion

The Economic Recovery Tax Act of 1981 provides for an exclusion of 15 percent of net interest received up to $3,000 of net interest ($6,000 on a joint return) beginning in 1985. Under the bill, the net interest exclusion will not become effective until 1987.

Exclusion From Gross Income for Cancellation of Certain Student Loans

The bill extends the exclusion for amounts realized by reason of cancellation of student loans in return for certain professional services for a two-year period, through December 31, 1984. Additionally, the bill broadens the exclusion to include loans made by tax-exempt public hospital corporations.

Phaseout of Graduated Rates for Large Corporations

Under present law, the first $100,000 of corporate taxable income is taxed at graduated rates. The taxable income in excess of $100,000 is taxed at the 46-percent rate. The graduated tax rates provide a tax reduction of $20,250 to corporations with taxable income in excess of $100,000 relative to a flat 46-percent tax.

The bill provides that the benefits of the graduated rates will effectively be phased out for any corporation with taxable income in excess of $1 million. An additional 5-percent tax, not to exceed $20,000 in amount, is imposed on a corporation's taxable income in excess of $1 million. This provision is effective for taxable years beginning after December 31, 1983.

Tax-Exempt Entity Leasing

Present law

The Federal income tax benefits of ownership of property generally include accelerated depreciation deductions and investment tax credits. Essentially, the law is that the economic substance of a transaction, not its form, determines who is entitled to the tax benefits associated with ownership. Thus, in a lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

The tax benefits of ownership are generally allowed only for property used for a business or income-producing purpose. They are not available for property that is owned by governmental units and tax-exempt organizations. Property that is used (though not owned) by a tax-exempt organization or a domestic governmental unit qualifies for accelerated cost recovery (ACRS) or other depreciation deductions but generally does not qualify for investment credits. For example, property used under a lease by one of those entities is ineligible with respect to the investment credit. A statutory exception to the investment credit limitation provides that qualified rehabilitation expenditures for a building leased to a tax-exempt organization or a governmental unit can qualify for the rehabilitation tax credit. Also, one court has held, and the Internal Revenue Service (IRS) has ruled, that investment credits can be claimed where a governmental unit essentially contracts not for the use of property itself, but rather for a service to be provided by the owner of the property.

Property used by a foreign government or person is not

subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States, then, in general, ACRS deductions are slowed down and no investment credit is allowed.

Only 50 percent of the investment credit otherwise allowable is allowable with respect to property owned by a thrift institution, but no such limitation specifically applies with respect to property leased to it. Furthermore, certain property owned by or leased to a public utility is subject to special depreciation and investment credit rules. However, those rules are not specifically applicable to property used to provide services to the public utility.

The bill

In general, the bill reduces the tax benefits available for certain property that is leased to or otherwise used by tax-exempt entities. Under the bill, tax-exempt entities include the United States, any State or local governmental unit, possessions of the United States, and most agencies and instrumentalities of any of the foregoing. The term also includes (1) organizations (other than farmers' cooperatives described in section 521) exempt from United States income tax and certain formerly exempt organizations and (2) certain foreign persons or entities.

The bill generally requires that ACRS or other depreciation deductions for property used by tax-exempt entities be computed using the straight-line method over a recovery period equal to the greater of the present class life of the property under the Asset Depreciation Range (ADR) system (40 years in the case of 15-year real property) or, in the case of property subject to a lease, 125 percent of the term of the lease. In the case of 15-year real property, this provision applies to the extent of use of a type or types specified in the bill, but only if more than 50 percent (35 percent in the case of use of a type or types specified in the bill by one tax-exempt entity and related tax-exempt entities) of the property is so used. The depreciation rules of the bill do not apply to certain short-lived property leased for a limited term. Depreciation deductions for property used by foreign persons or entities will be computed using the 175-percent declining balance method in 1984 and the 150-percent declining balance method after 1984.

The bill also provides criteria for determining whether a transaction that is structured as a service contract or other arrangement should be treated as a lease for all Federal income tax purposes. The rehabilitation credit is denied for tax-exempt use real property. Finally, lessors are denied investment credits with respect to property leased to thrift institutions in excess of the credits that would have been allowed to the lessee had the lessee owned the

property. Property used by foreign persons or entities and currently eligible for the investment credit is restricted to one-half of the credit for property placed in service in 1984 and generally is made ineligible for the credit after 1984.

The bill does not apply to property leased to a tax-exempt entity for a short term. For the investment credit, a short-term lease is a lease with a term of less than 6 months. For depreciation, the lease must be not more than 30 percent of the ADR midpoint (not to exceed 3 years). For certain foreign property, the depreciation rule applies to the investment credit as well.

The bill generally applies to property placed in service by the taxpayer after May 23, 1983, and to property used under an agreement entered into after that date. However, transitional rules are provided.

Six-Month Long-Term Holding Period and Reduction of Capital Loss Offset Against Ordinary Income

Gains and losses from the sale or exchange of capital assets held for more than 1 year are long-term capital gain or loss and gains and losses from capital assets held for 1 year or less are short-term, under present law. For noncorporate taxpayers, net capital losses may be deducted against $3,000 of ordinary income. However, only 50 percent of long-term losses realized after 1969 may be deducted against ordinary income.

The bill reduces the long-term capital gain and loss holding period to 6 months for assets acquired after November 1, 1983. For taxable years after 1983, the $3,000 ordinary income ceiling against which capital losses may be deducted is reduced to $1,000, and the special treatment of long-term losses realized prior to 1970 is repealed.

Sport Fish Restoration and Boating Safety Funds; Excise Tax on Certain Arrows

The bill replaces the present manufacturers excise tax on fishing equipment with an expanded tax imposed on the last sale of sport fishing equipment before retail. Certain articles are subject to the new tax at a 10-percent rate and others (i.e., tackle boxes, fishfinders, and electric outboard motors) at a 3-percent rate. The bill also extends the time for payment of the tax by manufacturers having $100,000 or less of gross sales receipts in the preceding calendar year, with payments by such taxpayers to be required on a quarterly basis.

Further, the bill alters the financing sources and expenditure purposes for the existing sport fish restoration and boating safety programs and the financing sources for the

Land and Water Conservation Fund. Among these changes, the bill transfers part of the revenues from the existing tax on motorboat fuels to the sport fish restoration program. The bill also transfers administration of funding for the sport fish restoration and boating safety programs to a new Aquatic Resources Trust Fund to be included in the Internal Revenue Code.

Finally, the bill expands the existing tax on arrows to include arrows used by crossbow hunters.

These provisions generally are effective on October 1, 1984; the tax on tackle boxes and fishfinders will apply on October 1, 1985.

Tax Straddle Provisions

Straddles rules applicable to options

Under present law, stock and exchange-traded stock options are not subject to the tax straddle rules. Options on futures contracts appear to be outside the mark-to-market rules applicable to regulated futures contracts (RFCs) although the taxpayer acquires an RFC when the option is exercised. Some argue that certain cash settlement options do not result in capital gain or loss under present law.

The bill brings stock options, and stock that is offset by an option, within the tax straddle rules. Options on futures are brought within the definition of RFCs. The bill clarifies that gains and losses from cash settlement options are capital gain and losses notwithstanding the cash-settlement feature.

Offshore commodity funds

Under present law, taxpayers contend that a foreign corporation that is widely held by U.S. persons may establish a subsidiary to invest in U.S. commodities markets without any of the parties incurring U.S. tax. They also contend that when the U.S. shareholders eventually dispose of their shares in the foreign corporation they will be subject to tax at only the capital gains rate.

The bill in certain cases applies the accumulated earnings tax to earnings from U.S. investments, even after those earnings pass through corporate solution as dividends or interest. It also generally treats gains of U.S. shareholders from such investments as ordinary income.

Corporations formed to straddle

Taxpayers may attempt to avoid the tax straddle rules by forming corporations, typically foreign corporations, to take

positions to offset their own. The bill treats such stock ownership as a position for the purposes of the straddle rules. This treatment would prevent a taxpayer from recognizing losses when the taxpayer uses a corporation for straddling purposes.

Collapsible Corporations

Under present law, a collapsible corporation is one which meets certain requirements, including a requirement that the corporation be formed or availed of with a view (on the part of its major shareholders) to realize the value of the corporation's collapsible assets before the corporation has realized a "substantial part" of the taxable income to be derived from such property. Under the bill, the substantial part requirement would be defined to be "two-thirds" of the taxable income to be derived from the property .

The "70/30" rule of present law is amended to authorize Treasury regulations specifying the extent to which all inventory assets must be aggregated and treated as a single asset in determining whether the gain attributable to such assets should be treated as attributable to collapsible assets for purposes of the "70/30" rule.

Compliance Provisions

The committee bill contains eight amendments concerning compliance with the Internal Revenue laws. The first relates to illegal-source income and cash transactions. Persons who receive more than $10,000 in currency in transactions related to their trade or business and persons who receive mortgage interest payments in excess of $2,300 must report on those receipts to the Internal Revenue Service.

Two additional provisions impose new information-gathering or reporting requirements. Specifically, promoters of tax shelter investments are required to maintain customer lists which may be examined by the Internal Revenue Service. The second reporting requirement relates to information on foreclosures, abandonments, and bad debt deductions which may give rise to discharge of indebtedness income to the borrower.

Two of the provisions adopted by the committee bill relate to the increasing backlog of cases in the Tax Court and the backlog of tax shelter cases. These provisions increase the dollar limit on small tax cases in the Tax Court to $10,000 and provide a special, higher interest rate in pre-1983 tax shelter cases for interest accruing after 1983.

The other compliance provisions of the committee bill increase the promoter penalty enacted in 1982, permit the Treasury to bar appraisers from practice before the Treasury,

and clarify the circumstances under which taxpayers using improper methods of accounting may be subjected to a penalty.

Withholding On Dispositions by Foreigners of United States Real Property Interests

Under the Foreign Investment in Real Property Tax Act of 1980, foreign persons who dispose of U.S. real property interests generally are required to pay tax on any gain realized on the disposition. The Act provides for enforcement of the tax on foreign persons through a system of information reporting designed to identify foreign owners of U.S. real property interests.

The bill allows replacement of the information reporting system with a withholding system. Generally, the bill requires withholding of a certain portion of the sales price by a transferee of U.S. real estate, any agent of a transferee, or any settlement officer or transferor's agent (hereinafter collectively referred to as the withholding agent) where U.S. real estate is acquired from a foreign person. Withholding is required only if the withholding agent knows (or has received notice from the transferor or his agent) that the transferor is a foreign person. The bill provides for exemptions from withholding in certain cases including that in which the transferee is to use the real property as his principal residence and the purchase price is $200,000 or less.