[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS (S. 1081, S. 1594, S. 1749, and S. 1764)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON NOVEMBER 6, 1981

PREPARED FOR THE USE OF THE

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on November 6, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are four bills scheduled for the hearing: S. 1081 (relating to deduction for self-insurance set-asides for liabilities of design professionals), S. 1594 (relating to increase in civil fraud penalty and limitation of penalty to portion of underpayment that is attributable to fraud), S. 1749 (relating to deductability of payments under the Foreign Corrupt Practices Act), and S. 1764 (relating to definitions concerning cooperative housing corporations).

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

I. SUMMARY

1. S. 1081—Senators Mathias, Long, Durenberger, Heinz, D'Amato, and Bentsen

Deduction for Self-insurance Set-asides for Liabilities of Design Professionals

Present law generally does not permit a taxpayer to deduct currently amounts set aside in a self-insurance fund or trust to satisfy contingent liabilities, such as future claims based on negligence or malpractice in furnishing services. Under the bill, architects, engineers, and other design professionals could elect to deduct currently amounts paid into a trust established by the taxpayer for the purpose of funding liabilities attributable to negligence or breach of warranty in the taxpayer's work. The deduction for any one year could not exceed $100,000 in the case of a taxpayer with a "severe service liability insurance problem" or $25,000 in the case of other eligible taxpayers.

Under present law, a trust established to provide funds to satisfy contingent liabilities generally does not qualify for tax-exempt status. The bill would provide that a self-insurance trust to which payments would be deductible would be exempt from income tax.

2. S. 1594—Senator Symms

Increase in Civil Fraud Penalty and Limitation of Penalty to Portion of Underpayment that is Attributable to Fraud

Present law imposes certain penalties on taxpayers who underpay taxes because of negligence or civil fraud (sec. 6653). The negligence penalty generally is 5 percent of any underpayment that is due, in whole or in part, to negligence or intentional disregard of rules or regulations but not with intent to defraud. The alternatve civil fraud penalty is 50 percent of any underpayment if any part of any underpayment is due to fraud.

The bill would provide that if any portion of an underpayment of tax is due to fraud, then there would be an addition to tax of an amount equal to 100 percent of that portion of the underpayment. The provision would be effective for additions to tax made after the date of enactment.

3. S. 1749—Senator Chafee

Deductibility of Payments Under the Foreign Corrupt Practices Act

Under present law (sec. 162(c)(1)), no deduction is allowed for payments to foreign government employees or officials if such pay-

ments would be illegal under any of the Federal laws of the United States, if the laws of the United States were applicable to the transaction. Since Federal law makes illegal virtually any payment to government officials or employees in return for favorable business dealings, this provision covers most conceivable situations where foreign bribes, kickbacks or similar payments are made. Present law thus attempts to prevent any reduction in tax arising from the payment of foreign bribes.

Under the bill, the provision disallowing a deduction for payments to foreign officials that would be illegal under Federal law if Federal law applied to the transaction would be amended to disallow a deduction only where the payment was in violation of the Foreign Corrupt Practices Act. This change would limit the applicability of section 162 (c)(1) since more transactions are made illegal by the Federal laws of the United States than are made illegal under the Foreign Corrupt Practices Act.

4. S. 1764—Senator Moynihan

Definitions Concerning Cooperative Housing Corporations

Under present law (sec. 216), a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid to the corporation which represent his or her proportionate share of allowable real estate taxes and interest relating to the corporation's land and buildings. (In addition, to the extent a tenant-stockholder uses depreciable property leased from the cooperative housing corporation in a trade or business or for the production of income, the tenant-stockholder is allowed to take depreciation deductions with respect to the stock the ownership of which gives the tenant-stockholder the right to lease such property.)

In general, for a corporation to qualify as a cooperative housing corporation (which can pass through real estate tax and interest deductions to tenant-stockholders) 80 percent or more of the gross income of the cooperative housing corporation must be derived from tenant-stockholders. The bill would reduce the 80-percent requirement to 50 percent. The bill also would remove the three-year limitation on the period during which an original seller who acquires stock of a cooperative housing corporation from the corporation or by foreclosure is treated as a tenant-stockholder.

II. DESCRIPTION OF BILLS

1. S. 1081—Senators Mathias, Long, Durenberger, Heinz, D'Amato, and Bentsen

Deduction for Self-insurance Set-asides for Liabilities of Design Professionals

Present law

Under present law, deductions by an accrual-basis taxpayer are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy (Treas. Reg. § 1.446-1(c) (1) (ii)). Accordingly, the income tax law generally does not permit a taxpayer to deduct currently amounts set aside in a self-insurance fund or trust to satisfy contingent liabilities, such as future claims based on negligent furnishing of architectural, engineering, or similar services.

Instead, deductions are allowed when liability for a particular act or omission and the amount of the liability have become fixed by litigation or settlement of a claim. Such losses that have been incurred in a trade or business, to the extent not used in the year first deductible, may be carried back for 3 years and carried forward for 15 years. The amount of premiums paid during the year for insurance against future claims generally is currently deductible as a business expense.

Also, under present law, a trust established to provide funds to satisfy contingent liabilities generally does not qualify for tax-exempt status.[1] For example, the tax law does not provide an exemption for income earned on assets set aside by an architect or engineer to satisfy liabilities from professional malpractice. Instead, the Internal Revenue Service takes the position that the income of such a trust is taxed directly to the grantor of the trust under the "grantor trust" rules of the Code.

In the case of product liability losses, the amount of a net operating loss attributable to the product liability can be carried back ten years

[1] However, Code section 501(c) (21) provides an income tax exemption for a qualified, irrevocable trust used by a coal mine operator to self-insure for liabilities, imposed on the operator by statute, to pay benefits to miners disabled with black lung disease. This provision requires as a condition of exemption that there be no right or possibility that either corpus or income of the trust can revert to the coal mine operator which established and funded the trust. Also, a black lung liability self-insurance trust is subject to strict self-dealing prohibitions, prohibitions on improper expenditures, and investment limitations. Contributions by the coal mine operator to fund an exempt section 501(c) (21) trust are deductible, within certain limitations (Code sec. 192).

(Code sec. 172(b)(1)(H)). This special rule does not apply to liabilities based on services performed by the taxpayer or to liabilities arising under warranty.

Issues

The principal issues are whether, as an exception to the general tax rule disallowing deductions for anticipated liabilities, there should be a deduction for amounts set aside to self-insure losses resulting from the furnishing of services by design professionals, such as architects and engineers; and if so, whether the earnings on amounts set aside to fund such liabilities should be exempt from income tax.

Other issues for consideration in connection with the bill include: (1) whether any deduction allowed for anticipated malpractice or warranty claims against design professionals should also be provided to other professionals subject to similar liabilities, such as contractors, lawyers, doctors, nurses, and accountants; (2) whether, as a condition for exemption of income earned on set-aside funds, there should be a requirement that the corpus or income of such funds could not revert to the taxpayer (other than for payment of the taxpayer's service liabilities); and (3) what limitations on investments should apply to assets of exempt set-aside trusts, and what prohibitions should be imposed on improper expenditures and "self-dealing".

Explanation of the bill

In general

Under the bill, an eligible taxpayer could elect to deduct the amount of cash transferred during the year to a trust established by the taxpayer for the purpose of funding the taxpayer's service liability. The deduction would be available to persons engaged in the trade or business of furnishing services in the professional design, surveying, planning, evaluation, preparation of studies or specifications, or inspection of construction as representative of the owner, for the constructtion or modification of a building or other structure.

The funds would have to be transferred to a trust established exclusively to satisfy service liability losses of the taxpayer. The term "service liability" would refer to the taxpayer's liability for personal or property damage attributable to negligence or defects in, or breach of warranty regarding, the design, etc., for the construction or modification of buildings or other structures.

The bill would impose various restrictions on a service liability trust eligible to receive deductible amounts. For example, the assets of the trust or insurer could not be borrowed, used as security for a loan, or otherwise used by the taxpayer except for payment of service liability losses,[2] and limits would be imposed on investment of such assets. The trustee of the service liability trust generally would have to be a bank, and trust funds could not be commingled with other assets.

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[2] The term "service liability loss" would mean any loss attributable to the taxpayer's service liability, including payment on claims against the taxpayer for service liability; expenses incurred in the investigation, settlement, and defense of any such claims; and administrative and other incidental expenses of a service liability trust in connection with the operation of the trust and the processing of claims against the taxpayer.

Limitation on deduction

The amount of the deduction for the year would be subject to a limitation. The amount of limitation would depend on whether the taxpayer has a "severe service liability insurance problem." [3]

Severe problem.—If the taxpayer has a severe liability insurance problem for the taxable year, the deduction would be limited to the lesser of: (1) five percent of gross receipts derived from the trade or business of furnishing qualified services; (2) 15 percent of average yearly gross receipts from the furnishing of qualified services during the base period,[4] reduced by the balance of the taxpayer's service liability trust; or (3) $100,000.

No severe problem.—In the case of a taxpayer who elects this provision and who does not have a severe service liability insurance problem, the deduction could not exceed the lesser of (1) two percent of gross receipts derived from the trade or business of furnishing qualified services; (2) ten percent of average yearly gross receipts from the furnishing of qualified services during the base period,[4] reduced by the balance of the taxpayer's service liability trust; or (3) $25,000.

Distributions

Authorized distributions from a service liability trust would be included in the gross income of the taxpayer for the taxable year in which such authorized distributions are made. However, the distribution shall not be treated as "compensation by insurance or otherwise" for purposes of determining the amount of the loss deductible under section 165(a).

In the case of an unauthorized distribution, the tax liability of the taxpayer would be increased by an amount equal to ten percent of the excess of the distribution over the allowable deduction for the taxable year for service liability losses. Generally, the ten-percent penalty would not apply if (1) a corrective withdrawal of an excess contribution is made prior to the last day (including extensions) for filing the taxpayer's return; (2) the taxpayer establishes to the satisfaction of the Internal Revenue Service that there was reasonable cause to create a service liability trust but that a change in circumstances has occurred which obviated the need for continuing the trust; (3) the distributed amount is, within 90 days of distribution, transferred to another service liability trust; (4) the distribution is made because of the liquidation of the taxpayer's trade or business, which may result in service liability; or (5) under Treasury regulations, the amount in the service liability trust is deemed to be distributed.[5]

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[3] A taxpayer would have a "severe service liability insurance problem" if the taxpayer is unable to obtain a premium quotation for service liability insurance, with coverage of up to $1 million, with a reasonable deductible amount (the deductible amount not exceeding the premium, in any case), from any insurer, or the lowest insurance premium quotation for service liability insurance coverage of up to $1 million, with a reasonable deductible amount (but not in excess of the premium), obtained by the taxpayer was equal to more than two percent of the gross receipts of the taxpayer for the taxable year.

[4] The base period would be the shorter of the period beginning with the earliest preceding taxable year for which the taxpayer elected this provision and ending with the current taxable year or a five-year period which includes the taxpayer's current and four preceding taxable years.

[5] In general, the funds in the service liability trust would be deemed to be distributed only if there is a transfer of more than 50 percent of the control of the taxpayer's trade or business.

Accumulations deemed reasonable

The bill also provides that, in the case of a corporation, amounts accumulated in the taxpayer's service liability trust would be deemed accumulated for the reasonable needs of the trade or business and thus not subject to the accumulated earnings tax (Code secs. 531–537).

Exempt status

Under the bill, the service liability trust of the taxpayer would be exempt from Federal income tax.

Effective date

The provisions of the bill would be effective with respect to taxable years beginning after the date of enactment.

Revenue effect

This bill is estimated to reduce fiscal year budget receipts by $22 million in 1982, $58 million in 1983, $67 million in 1984, $72 million in 1985, and $76 million in 1986. The estimate assumes the bill is effective for taxable years beginning after December 31, 1981.

2. S. 1594—Senator Symms

Increase in Civil Fraud Penalty and Limitation of Penalty to Portion of Underpayment that is Attributable to Fraud

Present law

Under present law, a taxpayer who underpays any income, gift, or windfall profit tax because of negligence, or any tax because of fraud, is subject to certain penalties (Code sec. 6653). The penalty for negligence is 5 percent of any underpayment if any part of the underpayment is due to negligence or intentional disregard of rules and regulations but not with intent to defraud. In addition, effective for the payment of taxes due after December 31, 1981, there is an addition to tax equal to one-half the interest payable with respect to the portion of an underpayment that is attributable to negligent or intentional disregard of rules and regulations.[1]

The fraud penalty is 50 percent of any underpayment of tax if any part of the underpayment is due to fraud. The negligence penalty does not apply if the fraud penalty is imposed. In the case of a joint return, this penalty does not apply with respect to the payment of tax by a spouse unless some part of the underpayment is due to the fraud of such spouse.

For purposes of these penalties, an underpayment generally is defined as a deficiency. Thus, it is the amount by which the tax imposed exceeds the amount of tax shown on a timely filed return.

Issue

The issue is whether the amount of the civil fraud penalty should be increased, on the one hand, but limited, on the other hand, to the portion of the underpayment that is due to fraud.

Explanation of the bill

The bill would increase the amount of the civil fraud penalty but would limit the penalty to the portion of an underpayment that is due to fraud.

Under the bill, if any portion of an underpayment of tax is due to fraud, then there would be an addition to tax of an amount equal to 100 percent of that portion of the underpayment. In a judicial proceeding, the United States would have the burden of establishing that a portion of a taxpayer's underpayment is due to fraud. If the U.S. carried this burden, then the burden of proof would shift to the taxpayer with respect to the issue of whether any other portion of such underpayment is not due to fraud.

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[1] This new penalty was added by section 722(b) of the Economic Recovery Tax Act of 1981 (P.L. 97-34).

Other provisions of the civil fraud penalty would remain unchanged. Thus, the penalty would continue to be in lieu of the negligence penalty. Furthermore, in the case of a joint return, the civil fraud penalty would not apply with respect to the tax of a spouse unless some portion of the underpayment was due to the fraud of such spouse.

Effective date

The provisions of the bill would apply to additions to tax made after the date of enactment.

Revenue effect

The revenue estimate for this bill is not available.

3. S. 1749—Senator Chafee

Deductibility of Payments Under the Foreign Corrupt Practices Act

Present law

Under present law (sec. 162(c)(1)), no deduction is allowed for payments to foreign government employees or officials if such payments would be illegal under any of the Federal laws of the United States, if the laws of the United States were applicable to the transaction. Since Federal law makes illegal virtually any payment to government officials or employees in return for favorable business dealings, this provision covers most conceivable situations where foreign bribes, kickbacks or similar payments are made. Present law thus attempts to prevent any reduction in tax arising from the payment of foreign bribes.

In a further attempt to curtail foreign bribes by U.S. businessmen Congress enacted the Foreign Corrupt Practices Act of 1977 ("FCPA"). In general, this Act makes it illegal for U.S. persons or their agents to make, offer, or authorize either directly or indirectly, payments to foreign government officials, foreign political parties, or foreign political candidates with the intent of influencing official action in order to obtain business. Violations under FCPA can result in fines of up to $1 million for corporations and $10,000 for individuals, and imprisonment for up to five years.

Issue

The issue is whether the tax law should be changed to allow taxpayers a deduction for payments to foreign officials if those payments do not violate the Foreign Corrupt Practices Act.

Explanation of the bill

Under the bill, the provision disallowing a deduction for payments to foreign officials that would be illegal under Federal law if Federal law applied to the transaction would be amended to disallow a deduction only where the payment was in violation of the Foreign Corrupt Practices Act. This change would limit the applicability of Code section 162(c)(1) since more transactions are made illegal by the Federal laws of the United States than are made illegal under the Foreign Corrupt Practices Act.

There are two principal types of payments that would be allowed as a deduction under the bill that are not deductible under present law. The first are facilitating or "grease" payments. These are payments made to government officials to facilitate routine administrative actions that are nondiscretionary on their part. Thus, payments to a customs official to expedite goods through customs would be allowed as a deductible payment under the bill.

The second type of payment that would be deductible under the bill is one that is a legal payment under the local law of the foreign jurisdiction but which violates a Federal law other than the Foreign Corrupt Practices Act.

Effective date

The provisions of the bill would be effective for payments made after the date of enactment.

Revenue effect

The revenue estimate for this bill is not available.

4. S. 1764—Senator Moynihan

Definitions Concerning Cooperative Housing Corporations

Present law

Under present law (sec. 216), a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid to the corporation which represent his or her proportionate share of allowable real estate taxes and interest relating to the corporation's land and buildings. (In addition, to the extent a tenant-stockholder uses depreciable property leased from the cooperative housing corporation in a trade or business or for the production of income, the tenant-stockholder is allowed to take depreciation deductions with respect to the stock the ownership of which gives the tenant-stockholder the right to lease such property.)

In general, for a corporation to qualify as a cooperative housing corporation (which can pass through real estate tax and interest deductions to tenant-stockholders), 80 percent or more of the gross income of the cooperative housing corporation must be derived from individual tenant-stockholders.

Under the Revenue Act of 1978 (P.L. 95–600), as amended by the Technical Corrections Act of 1979 (P.L. 96–222), if an original seller (i.e. a person who conveys apartments or houses (or leaseholds therein) to a cooperative housing corporation) acquires stock of a cooperative housing corporation either from the corporation or by foreclosure, the original seller shall be treated as a tenant-stockholder for a period not to exceed three years from the date of the acquisition of the stock. However, except in the case of an acquisition of stock of a cooperative housing corporation by foreclosure, this rule only applies to stock acquired from the cooperative housing corporation which occurs not later than one year after the date on which the apartments or houses (or leaseholds therein) are transferred by the original seller to the corporation.

Issues

The issues are (1) whether the requirement that 80 percent or more of the gross income of a cooperative housing corporation must be derived from tenant-stockholders should be reduced, and (2) whether the three-year limitation on the period during which an original seller who acquires stock of a cooperative housing corporation from the corporation or by foreclosure is treated as a tenant-stockholder should be removed.

Explanation of the bill

The bill would provide that in order for a corporation to qualify as a cooperative housing corporation at least 50 percent of its gross income must be derived from tenant-stockholders, thereby reducing the 80-percent requirement under present law.

The bill also would provide that if an original seller acquires any stock of the cooperative housing corporation from the corporation within one year after the transfer of the dwelling units, or by foreclosure, the original seller shall be treated as a tenant-stockholder. The three-year limitation on such treatment under present law would be removed.

Effective date

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

Revenue effect

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

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