[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS (H.R. 4667, H.R. 4948, H.R. 5177, H.R. 5470, and H.R. 5573)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON JUNE 14, 1982

PREPARED FOR THE USE OF THE

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BY THE STAFF OF THE

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CONTENTS

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on June 14, 1982, before the House Ways and Means Subcommittee on Select Revenue Measures.

There are five bills scheduled for the hearing: H.R. 4667 (relating to charitable contributions of certain inventory to scientific research organizations); H.R. 4948 (extension of cash and deferred plan rules to salary reduction arrangements under money purchase pension plans); H.R. 5177 (conveyance of certain land to Fort Carson as involuntary conversion); H.R. 5470 (exclusion from gross income of certain payments for personal injury damages); and H.R. 5573 (special one-year rules for charitable contributions of technological equipment to primary and secondary schools).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of each bill, including present law, issues, explanation of the bill, effective date, and revenue effect.

I. SUMMARY

1. H.R. 4667—Mr. Guarini and others

Charitable Contributions of Certain Inventory to Scientific Research Organizations

Under present law, the amount of charitable deduction allowed for a contribution of ordinary-income property (such as a donation of inventory by a manufacturer) generally is limited to the donor's cost basis in the property. However, a special rule, enacted in the Economic Recovery Tax Act of 1981, applies to corporate donations of newly manufactured scientific equipment to a college or university to be used for research in the United States in the physical or biological sciences (Code sec. 170(e)(4)). Under this special rule, the corporate donor may deduct the sum of its basis in the property plus one-half of the unrealized appreciation (i.e., one-half of the difference between fair market value and basis), but not in excess of twice the basis of the property.

The bill would make this special charitable deduction rule also apply to qualifying corporate contributions of newly manufactured scientific equipment to scientific research organizations which are tax-exempt under section 501(c)(3) and which are not private foundations. The provisions of the bill would apply retroactively to charitable contributions made after August 13, 1981 (the effective date for the ERTA provision for corporate donations of newly manufactured scientific equipment to a college or university for research use).

2. H.R. 4948—Mr. Matsui

Extension of Cash and Deferred Plan Rules to Salary Reduction Arrangements Under Money Purchase Pension Plans

The Employee Retirement Income Security Act of 1974 (ERISA) provided that amounts deferred by an employee pursuant to a cash or deferred arrangement under a tax-qualified profit-sharing, stock bonus or money purchase pension plan are excluded from the employee's income if (1) the plan was in existence on June 27, 1974, and (2) the applicable requirements of prior law were satisfied. This tax treatment for existing plans was preserved, pending study by the Congress of the appropriate treatment for cash or deferred arrangements.

Under the Revenue Act of 1978, amounts deferred by an employee after 1979 pursuant to a cash or deferred arrangement under a tax-qualified profit-sharing or stock bonus plan are excluded from the employee's income only if certain requirements added by the Act are met. No rules were provided by the 1978 Act for cash or deferred arrangements under money purchase pension plans.

Under the bill, amounts deferred by an employee pursuant to a salary reduction arrangement under a money purchase pension plan would be excluded from the employee's income if the plan was in existence on June 27, 1974, and contributions by employees and by the employer do not exceed the levels permitted under the plan's contribution formula on that date. In addition, the plan would be required to satisfy rules added by the 1978 Act with respect to employee participation and prohibited discrimination in favor of officers, shareholders, or highly compensated employees. The bill would apply to money purchase pension plans maintained by taxable employers or tax-exempt organizations. The bill generally would apply retroactively for plan years beginning after 1980, and to contributions made after that date.

3. H.R. 5177—Mr. Brinkley and others

Conveyance of Certain Land to Fort Carson as Involuntary Conversion

Under present law, a taxpayer may elect not to recognize gain realized on the involuntary conversion of property if the taxpayer acquires, within a specified replacement period, property which is similar or related in service or use (Code sec. 1033). In such a situation, gain is recognized only to the extent that the amount realized exceeds the cost of the replacement property. The basis of the replacement property generally is that of the converted property, decreased by any gain not recognized.

The bill provides that conveyances (other than by gift) to the United States of privately owned lands located in the vicinity of the Purgatory River Canyon and Pinon Canyon, Colorado, for expansion of the Fort Carson military installation would be treated as involuntary conversions under section 1033. As a result, the landowners could elect to avoid recognition of gain at the time of the conveyances. The bill would be effective on enactment.

4. H.R. 5470—Messrs. Jacobs, Holland, Guarini, Duncan, and Vander Jagt [1]

Exclusion from Gross Income of Certain Payments for Personal Injury Damages

Present law excludes from gross income certain types of compensation payments for personal injuries or sickness, including damages received under a suit or settlement of a claim, amounts received from accident and health insurance, and certain disability income allowances (sec. 104). The Internal Revenue Service has ruled that damages for personal injury are excludable from gross income under section 104 whether paid as a lump sum, or paid in periodic payments out of a fund invested and owned by the tortfeasor or an insurer.

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[1] H.R. 5470 is generally identical to H.R. 4356 (Messrs. Goldwater and Rousselot) and H.R. 5732 (Mr. Holland), except that the latter two bills would be effective for taxable years ending after 1980.

The bill would expand the types of compensation payments for personal injuries which are listed in section 104 as excludable from gross income specifically to include amounts received by an assignee of an obligation to pay personal injury damages and used by the assignee to satisfy that obligation. Also, the bill would statutorily adopt the rulings position of the Revenue Service that the section 104 exclusion applies to certain periodic payments, by the tortfeasor or the assignee, of damages for personal injuries or sickness. Finally, the bill would amend section 162 (deduction for trade or business expenses) to provide expressly that the assignee may deduct under that section the amount of damages paid during the year.

The provisions of the bill would be effective for taxable years ending after 1981.

5. H.R. 5573—Messrs. Stark, Shannon, Bafalis, Gephardt, Holland, Rangel, Archer, and others

Special One-Year Rules for Charitable Contributions of Technological Equipment to Primary and Secondary Schools

Under present law, the amount of charitable deduction allowed for a contribution of ordinary-income property (such as a donation of inventory by a manufacturer) is limited, subject to certain exceptions, to the donor's cost basis in the property (sec. 170(e)). Also under present law, the maximum charitable deduction allowed to a corporation in one year for the total amount of its contributions is 10 percent of the corporation's taxable income for the year, with a five-year carryover of any excess.

The bill would provide special deduction rules for a charitable contribution by a corporation of a computer, or other sophisticated technological equipment, to a primary or secondary school for use directly in the education of students.

Under the bill, a deduction would be allowed for the sum of the donor's cost basis in the property plus 50 percent of the difference between the property's fair market value and basis, but not to exceed twice the basis. Also, the bill would increase, to up to 30 percent of taxable income, the limitation on the aggregate amount deductible in one year by a corporate donor on account of such contributions.

The special charitable deduction rules under the bill would apply to qualifying donations of computers or other sophisticated technological equipment only if made within one year after enactment of the bill.

II. DESCRIPTION OF BILLS

1. H.R. 4667—Mr. Guarini and others

Charitable Contributions of Certain Inventory to Scientific Research Organizations

Present law

Contributions by corporations

A corporation may deduct, within certain limitations, the amount of cash or other property contributed to qualified charitable organizations (Code sec. 170). This charitable deduction is limited to 10 percent of the corporation's taxable income (computed with certain adjustments) for the year in which the contributions are made. If the amount contributed exceeds the percentage limitation, the excess may be carried forward and deducted over five succeeding years, subject to the percentage limitation in those years.

Reduction in contribution amount

The amount of charitable deduction otherwise allowable for donated property generally must be reduced by the amount of any ordinary income which the donor would have realized had the property been sold for its fair market value at the date of the contribution (sec. 170(e)).[1] Thus, a donor of appreciated ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than the fair market value. For example, a manufacturer which donates a product from its inventory generally may deduct only its inventory cost for the item.

Special rules for certain corporate contributions

Under present law, charitable contributions by corporations of two types of ordinary-income property, if donated to certain exempt organizations for specified purposes, are subject to a different reduction rule.

The first exception, enacted in the Tax Reform Act of 1976, is for corporate donations of ordinary-income property to a charitable organization to be used solely for care of the needy, the ill, or infants (such as donations by the producer or manufacturer of food, clothing, or medical equipment), where such use is related to the donee's charitable functions (sec. 170(e)(3)). The second exception, enacted

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[1] In the case of donations of tangible capital gain property, the amount taken into account as a charitable contribution must be reduced by a portion of the appreciation if the use of the donated item by the donee charity is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations.

in the Economic Recovery Tax Act of 1981, is for corporate donations of newly manufactured scientific equipment to a college or university to be used for research (or research training) in the United States in the physical or biological sciences (sec. 170(e)(4)).

In the case of a charitable contribution of inventory which qualifies under one of these exceptions, the corporate donor generally is allowed a deduction equal to the sum of its basis in the property plus one-half of the unrealized appreciation (i.e., the difference between fair market value and basis). However, in no event is a deduction allowed for an amount in excess of twice the basis of the property (sec. 170(e)(3)(B)).

These two exceptions were enacted because the Congress concluded that it was desirable to provide a larger tax incentive than would be available if the general reduction rule applied for charitable contributions by corporations of certain ordinary-income property to specified types of charities for particular purposes. At the same time, the Congress also determined that the deduction so allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

Issue

The issue is whether an exception to the general reduction rule (applicable to charitable contributions of ordinary-income property) should be provided for corporate contributions of newly manufactured scientific equipment to certain tax-exempt scientific research organizations; i.e., should any deduction in excess of the cost of the goods to the donor be allowed.

Explanation of the bill

General rule

The bill would allow corporations (with certain exceptions)[2] a larger deduction than under present law for certain charitable contributions of new tangible personal property which is of an inventory nature (within the meaning of sec. 1221(1)), if contributed to an organization which is operated primarily to conduct scientific research, which is exempt from Federal income tax under section 501(c)(3), and which is not a private foundation.

Requirements for favorable treatment

To qualify, a corporate contribution of ordinary-income property to a tax-exempt scientific research organization must satisfy the following requirements:

(1) The property contributed was constructed by the donor;[3]

(2) The contribution is made within two years of substantial completion of construction of the property;

(3) The original use of the property is by the research organization;

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[2] The provision does not apply in the case of a corporation which is a subchapter S corporation, as defined in sec. 1371(b); a personal holding company, as defined in sec. 542; or a service organization, as defined in sec. 414(m)(3).

[3] Under Treasury regulations, property is to be treated as constructed by the taxpayer only if the cost of parts (other than parts manufactured by the taxpayer or a related person) used in construction do not exceed 50 percent of the taxpayer's basis in the property.

(4) The property is scientific equipment or apparatus substantially all the use of which by the donee is for research or experimentation (within the meaning of sec. 174), or for research training, in the United States in the physical or biological sciences; [4]

(5) The donated property is not transferred by the research organization in exchange for money, other property, or services; and

(6) The donor receives the research organization's written statement representing that the use and disposition of the property contributed will be in accordance with the last two requirements.

Allowable deduction

If all the conditions are satisfied, the charitable deduction allowed by the bill generally would be for the sum of (1) the taxpayer's basis in the property, plus (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value [5] determined at the time of the contribution and the donor's basis in the property). However, in no event would a deduction be allowed for any amount in excess of twice the basis of the property.

For example, if a manufacturer makes a qualifying contribution to a scientific research organization of an electron microscope with a cost basis of $\$5X$, and a fair market value of $\$16X$, the bill would allow the manufacturer a charitable deduction of $\$10X$ (twice the $\$5X$ basis). Assuming a 46 percent tax bracket, the effect of the deduction under the bill would be to reduce the manufacturer's tax liability by $\$4.6X$, or 92 percent of the cost of manufacture. The out-of-pocket cost of the donation to the manufacturer, exclusive of distribution and other expenses, would then be $\$0.4X$, or 8 percent of the manufacturer's cost. If in the example the fair market value of the electron microscope was $\$11X$, the deduction would be $\$8X$ ($\$5X$ basis plus ½ of the $\$6X$ difference between value and basis), and the out-of-pocket cost to the manufacturer would be $\$1.32X$ ($\$5X$ cost less $\$3.68X$ tax benefit).

Effective date

The provisions of the bill would apply retroactively to charitable contributions made after August 13, 1981 (the effective date for the provision enacted in the Economic Recovery Tax Act of 1981 for corporate donations of newly manufactured scientific equipment to a college or university for research use).

Revenue effect

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

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[4] For purposes of the fourth requirement listed above, the term "substantially all" means at least 80 percent.

[5] Where donated property is of a type which the taxpayer sells in the course of its business, the fair market value is the price which the taxpayer would have received if the taxpayer had sold the contributed property in the usual market in which it customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom it customarily sells; but if it sells only at retail, the usual market consists of its retail customers (Reg. § 170A-1(c)(2)).

2. H.R. 4948—Mr. Matsui

Extension of Cash and Deferred Plan Rules to Salary Reduction Arrangements Under Money Purchase Pension Plans

Background and present law

In general

A money purchase pension plan is a defined contribution plan under which each participant's pension benefit is based solely on the balance of the participant's account, consisting of contributions, income, gain, expenses, loss, and forfeitures allocated from the accounts of other participants.[1] Profit-sharing plans are also defined contribution plans.

Under a cash or deferred profit-sharing plan, or under a money purchase pension plan with a salary reduction arrangement, the employer gives an employee the choice of (1) receiving a specified amount in cash as current compensation or (2) having that amount contributed to the plan.

In December 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of cash or deferred profit-sharing plans and money purchase pension plans with salary reduction arrangements. (These proposed regulations were withdrawn in July 1978). Under the rules in effect at the time of the proposal, an employee generally was not taxed currently on amounts the employee chose to have contributed to a tax-qualified cash or deferred profit-sharing plan or salary reduction money purchase pension plan. Under the proposed regulations, amounts contributed to a plan due to the election of the employee would be included in the employee's income.

Freeze on tax treatment

In order to allow time for Congressional study of this area, the Employee Retirement Income Security Act of 1974 (ERISA) provided that the tax treatment of contributions to cash or deferred profit-sharing plans or salary reduction money purchase plans in existence on June 27, 1974 was to be governed under the law as it was applied prior to January 11, 1972. Accordingly, employer contributions to these cash or deferred profit-sharing plans were not includible in the income of covered employees, provided the plans satisfied the requirements of pre-1972 law and otherwise complied with the tax-qualification rules. Under ERISA, this freeze in tax treatment was continued through 1976, or (if later) until regulations were issued in final form which would change the pre-1972 administration of the law. The freeze was subsequently extended through 1979.

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[1] Under a defined benefit pension plan, a participant's benefit is specified independently of an account for contributions, etc. (e.g., an annual benefit of two percent of average pay for each year of employee service).

Revenue Act of 1978

The Revenue Act of 1978 provided rules for new and old profit-sharing plans with cash or deferred arrangements. The new rules, which also apply to stock bonus plans, are effective for plan years beginning after 1979. For years beginning before 1980, the tax treatment under a plan in existence on June 27, 1974, is determined under prior law. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

Issue

The principal issue is whether the tax-qualification rules should permit salary reduction arrangements under money purchase pension plans on the same basis as cash or deferred arrangements are permitted under profit-sharing and stock bonus plans.

Explanation of the bill

The bill would revise the tax-qualification rules to permit a qualified money purchase pension plan which was in existence on June 27, 1974, and which provided for a salary reduction arrangement on that date, to continue the arrangement after 1979. However, the bill's revision to the tax-qualification rules would apply only to those money purchase pension plans under which employer and employee contributions may not exceed the levels (e.g., as a percentage of pay) provided under the plan's contribution formula on June 27, 1974.

In addition, for plan years beginning after 1979, a salary reduction arrangement under a money purchase pension plan would be required to meet the special tax-qualification rules for cash or deferred arrangements added by the 1978 Act with respect to employee eligibility to participate in the arrangement and to prohibited discrimination in favor of employees who are officers, shareholders, or highly compensated. These rules presently apply to cash or deferred arrangements under qualified profit-sharing or stock bonus plans.

The provisions of the bill would apply to salary reduction arrangements under money purchase pension plans of taxable employers and tax-exempt organizations.

Effective date

The bill would apply retroactively for plan years beginning after December 31, 1980, and to contributions made after that date. A transition rule is provided for contributions made after 1979, and before the beginning of the first plan year beginning after 1980.

Revenue effect

An estimate of the effect of the bill on budget receipts is not available at this time.

3. H.R. 5177—Mr. Brinkley and others

Conveyance of Certain Lands to Fort Carson as Involuntary Conversions

Present law

Under present law, a taxpayer may elect not to recognize gain realized on the involuntary conversion of property if the taxpayer acquires, within a specified replacement period,[1] property which is similar or related in service or use to the involuntarily converted property (Code sec. 1033). In such a situation, gain is recognized only to the extent that the amount realized exceeds the cost of the replacement property. The basis of the replacement property generally is that of the converted property, decreased by any gain not recognized.

If real property (not including stock in trade or other property held primarily for sale) held for productive use in a trade or business or for investment is involuntarily converted, then property of a "like kind" to be held either for productive use in a trade or business or for investment is treated as property similar or related in service or use to the converted property (sec. 1033(g)(1)). The term "like kind" refers to the nature or character of the property converted.

Issue

The issue is whether conveyances (other than by gift) of privately owned lands located in the vicinity of the Purgatory River Canyon and Pinon Canyon, Colorado, to the United States for expansion of the Fort Carson military installation should be treated as involuntary conversions under section 1033, so that the landowners could elect to avoid recognition of gain at the time of the conveyances.

Explanation of the bill

The bill provides that conveyances (other than by gift) to the United States of privately owned lands located in the vicinity of the Purgatory River Canyon and Pinon Canyon, Colorado, for expansion of the Fort Carson military installation would be treated as involuntary conversions under section 1033.

The bill is intended to apply only to those landowners whose land is actually acquired for expansion of Fort Carson under the Military Construction Authorization Act of 1982. The bill would provide involuntary conversion treatment for such conveyances of land whether or not such conveyances otherwise satisfied the technical requirements for involuntary conversion treatment under present law.

Effective date

The bill would be effective on enactment.

Revenue effect

An estimate of the effect of the bill on budget receipts is not available at this time.

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[1] The replacement period is, in general, the period beginning with the date of the disposition of the converted property (or the earliest of the threat or imminence of the condemnation of the converted property, if earlier than the disposition date), and ending two years after the close of the first taxable year in which any part of the gain on conversion is realized.

4. H.R. 5470—Messrs. Jacobs, Holland Guarini, Duncan, and Vander Jagt [1]

Exclusion from Gross Income of Certain Payments for Personal Injury Damages

Present law

In general, present law (Code sec. 104) excludes from gross income the following types of compensation payments for personal injuries or sickness:

(1) certain amounts received under worker's compensation laws (if paid for personal injuries or sickness);

(2) damages received under a suit or settlement of a claim;

(3) amounts received through accident and health insurance (unless received by an employee and either attributable to employer contributions that were not includible in the gross income of the employee, or else paid directly by the employer);

(4) pensions, annuities, or similar allowances for personal injuries or sickness resulting from active service in the armed forces of any country, the Coast and Geodetic Survey, or the Public Health Service, or a disability annuity paid under the Foreign Service Act; and

(5) amounts received as disability income by a United States employee who was injured by terrorist violence while performing official duties outside the United States.

However, to avoid a double tax benefit, an exclusion is not allowed for such compensation payments to the extent attributable to (and not exceeding) deductions allowed to the recipient as medical expenses in a prior year.

Generally, the Internal Revenue Service has ruled that damages for personal injury are excludable from gross income under section 104 whether paid as a lump sum. or paid in periodic payments out of a fund invested and owned by the tortfeasor or an insurer (see Rev. Rul. 77-230, 1977-2 C.B. 214; [2] Rev. Rul. 79-220, 1979-2 C.B. 74; [3] and

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[1] H.R. 5470 is generally identical to H.R. 4356 (Messrs. Goldwater and Rousselot) and H.R. 5732 (Mr. Holland), except that the latter two bills would be effective for taxable years ending after 1980.

[2] Rev. Rul. 77-230 holds that distributions from a trust established and owned by the United States under a settlement agreement stemming from an individual's suit for injuries sustained at a government facility, and requiring payment of the individual's future medical expenses from the income or corpus of the trust, are excludable from the individual's gross income. Under the facts of the ruling, any trust assets (accumulated income or corpus) remaining on the individual's death would revert to the government.

[3] Rev. Rul. 79-220 holds that where the insurer of a tortfeasor purchases and retains exclusive ownership of a single-premium annuity contract to fund specified monthly payments for a fixed period pursuant to settlement of a damage suit for personal injuries, the recipient may exclude from his or her gross income the full amount of the payments, and not merely the discounted present value. The taxpayer's only right with respect to the amount invested was to receive the monthly payments, and the ruling concluded that the taxpayer not have actual or constructive receipt or economic benefit of the amount invested.

Rev. Rul. 79–313, 1979–2 C.B. 75).[4] However, the exclusion of damages for personal injury does not apply to investment income generated from a lump-sum award invested by or on behalf of the taxpayer (Rev. Rul. 76–133, 1976–1 C.B. 34).

Issues

The principal issue is whether periodic payments of damages for personal injury, whether paid by the person originally liable for such damages or by an assignee of the tortfeasor, should, by express statutory provision, be excluded from the gross income of the recipient. Other issues are whether amounts received by an assignee to fund an obligation to pay damages in periodic payments should be excluded from gross income, and whether amounts paid by such assignee to a recipient of personal injury damages should be deductible as ordinary and necessary business expenses.

Explanation of the bill

The bill would expand the types of compensation payments for personal injuries which are specified in section 104 as excludable from gross income to include amounts received by an assignee of an obligation to pay personal injury damages and used by the assignee to satisfy that obligation.

Also, the bill would statutorily adopt the rulings position of the Internal Revenue Service that the section 104 exclusion applies to certain periodic payments of damages for personal injuries or sickness received from or through either the person originally liable for the damages or an assignee of the person originally liable. This rule would apply only if the assignee is subject to the same rights and liabilities of such person, and only if the recipient cannot accelerate, defer, increase, or decrease the periodic payments from the assignee.

Finally, the bill would amend section 162 (deduction for trade or business expenses) to provide expressly that the assignee may deduct the amount of damages paid during the year under that section.

Effective date

The provisions of the bill would be effective for taxable years ending after 1981.

Revenue effect

An estimate of the effect of the bill on budget receipts is not available at this time.

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[4] Rev. Rul. 79–313 holds that if, in a personal injury settlement, the insurer of a tortfeasor agrees to make 50 consecutive annual payments (increasing by five percent a year), the entire amount of the payments received is excludable from the recipient's gross income under sec. 104(a)(2). The taxpayer did not have any right to accelerate or modify the amount of payments, and the insurer was not required to set aside specific assets to secure any part of its obligation. The ruling concluded that the taxpayer did not have actual or constructive receipt, or economic benefit, of the present value of the damages.

5. H.R. 5573—Messrs. Stark, Shannon, Bafalis, Gephardt, Holland, Rangel, and Archer, and others

Special One-Year Rules for Charitable Contributions of Technological Equipment to Primary and Secondary Schools

Present law

General reduction rule

A taxpayer generally may deduct, within certain limitations, the amount of cash or the fair market value of other property contributed to qualified charitable organizations. However, the amount of charitable deduction otherwise allowable for donated property generally must be reduced by the amount of any ordinary income which the donor would have realized had the property been sold for its fair market value at the date of the contribution (Code sec. 170(e)).[1] Thus, a donor of appreciated ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than the fair market value. For example, a manufacturer which donates a product from its inventory generally may deduct only its inventory cost for the item.

Special rules for certain corporate contributions

Under present law, charitable contributions by corporations of two types of ordinary-income property, if donated to certain exempt organizations for specified purposes, are subject to a different reduction rule.

The first exception, enacted in the Tax Reform Act of 1976, is for corporate donations of ordinary-income property to a charitable organization to be used solely for care of the needy, the ill, or infants (such as donations by the producer or manufacturer of food, clothing, or medical equipment), where such use is related to the donee's charitable functions (sec. 170(e)(3)). The second exception, enacted in the Economic Recovery Tax Act of 1981, is for corporate donations of newly manufactured scientific equipment to a college or university to be used for research (or research training) in the United States in the physical or biological sciences (sec. 170(e)(4)).

In the case of a charitable contribution of inventory which qualifies under one of these exceptions, the corporate donor generally is allowed a deduction equal to the sum of its basis in the property plus one-half of the unrealized appreciation (i.e., the difference between fair market value and basis). However, in no event is a deduction allowed for

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[1] In the case of donations of tangible capital gain property, the amount taken into account as a charitable contribution must be reduced by a portion of the appreciation if the use of the donated item by the donee charity is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations.

an amount in excess of twice the basis of the property (sec. 170(e)(3)(B)).

These two exceptions were enacted because the Congress concluded that it was desirable to provide a larger tax incentive than would be available if the general reduction rule applied for charitable contributions by corporations of certain ordinary-income property to specified types of charities for particular purposes. At the same time, the Congress also determined that the deduction so allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

Overall deduction limitation

The total charitable deduction allowed to a corporation is limited to 10 percent of the corporation's taxable income (computed with certain adjustments) for the year in which the contributions are made. (This limitation was raised from five percent by the Economic Recovery Tax Act of 1981.) If the amount contributed exceeds the percentage limitation, the excess may be carried forward and deducted over five succeeding years, subject to the percentage limitation in those years.

Issues

1. The first principal issue is whether contributions by a business to schools for use in educating students where there could be a benefit to the donor (e.g., through increasing a market for its products) should be treated for income tax purposes as charitable contributions (in which case a charitable deduction may be allowed for an amount in excess of the cost basis of the donated item), or as noncharitable promotional expenditures (in which case the deduction would be limited to the item's cost to the donor).[2]

2. If such contributions are to be treated as charitable contributions, the second principal issue is whether an exception to the general reduction rule applicable to charitable contributions of inventory should be made in the case of qualifying contributions of computers, etc.; i.e., should any deduction in excess of the cost of the goods to the donor be allowed, and if so, how much. Related issues are (a) what kinds of property should be eligible for any special treatment (for example, should all types of sophisticated technological equipment be eligible or only computers, and if so limited, how qualifying computers should

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[2] In *Singer Co.* v. *U.S.*, the U.S. Court of Claims upheld IRS denial of charitable deductions claimed by a manufacturer for the amount of discounts allowed on purchases of sewing machines by schools and colleges (449 F.2d 413) (Ct. Cl. 1971)).

In that case, the court had found that the school discounts were offered "for the predominant purpose of encouraging [the schools] to interest and train young women in the art of machine sewing, thereby enlarging the future potential market by developing prospective purchasers of home sewing machines and, more particularly, Singer machines—the brand on which the future buyers learned to sew." The court concluded that the manufacturer's predominant reason for granting such discounts was other than charitable, notwithstanding that the company said it would have provided the discounts even if it had a total monopoly of the sewing machine market, and even though a company survey showed that fewer than two percent of its regular retail customers had been influenced in buying by previous school training. Since the company expected a return in the nature of future increased sales, the court concluded that the company received a *quid pro quo* for the discounts which was substantial and was therefore inconsistent with allowing charitable deductions.

be defined); (b) whether any special treatment should be accorded to all taxpayers, or limited (for example) to manufacturers; and (c) whether any special treatment should be limited to taxpayers which actually construct the donated property.

3. The third principal issue is whether, in the case of such contributions, the limitation on the aggregate charitable deduction allowed in one year to a corporation should be increased above the general 10 percent limitation.

Explanation of the bill

Overview

The bill would provide a larger charitable deduction (than would be allowed under the general reduction rule), and would increase the general limitation on the aggregate amount of corporate contributions deductible in a year, for charitable contributions by corporations of computers or other sophisticated technological equipment, if contributed to a primary or secondary school, and if used by the school directly in the education of students. These special charitable deduction provisions would apply only to qualifying donations which are made within one year after enactment of the bill.

The principal intended beneficiary of the bill is Apple Computer, Inc. The provisions of the bill would also benefit any other corporate taxpayer which, during the one-year period following enactment of the bill, makes qualifying charitable contributions of computers or other sophisticated technological equipment.

Requirements for favorable treatment

In order for the special deduction rules of the bill to apply, there must be a charitable contribution (as defined under sec. 170(c)) by a corporation [3] which satisfies the following requirements:

(1) The donated property is a computer or other sophisticated technological equipment or apparatus, and is tangible personal property of an inventory nature (within the meaning of sec. 1221(1));

(2) The property is donated to an educational organization (described in sec. 170(b)(1)(A)(ii)) [4] other than an institution of higher education (as defined in sec. 3304(f)); [5]

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[3] The bill would not apply in the case of a corporation which is a subchapter S corporation (as defined in sec. 1371(b)); a personal holding company (as defined in sec. 542); or a service organization (as defined in sec. 414(m)(3)).

[4] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, * * *" and includes both public and private schools (Reg. § 1.170A–9(b)(1)).

[5] An institution of higher education, as defined in sec. 3304(f), means an educational institution which (1) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate; (2) is legally authorized to provide a program of education beyond high school; (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 occupation; and (4) is a public or other nonprofit institution.

(3) The contribution is made within two years of substantial completion of construction of the property,[6] and within one year after the enactment of the bill;

(4) The original use of the donated property is by the school;

(5) All the use of the donated property by the school is directly in the education of students in the United States;

(6) The donated property is not transferred by the school in exchange for money, other property, or services; and

(7) The donor receives a written statement from the school representing that the use and disposition of the donated property will be in accordance with the last two requirements.

Allowable deduction

If all the conditions are satisfied, the charitable deduction allowed by the bill generally would be for the sum of (1) the taxpayer's basis in the property, plus (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value[7] determined at the time of the contribution and the donor's basis in the property). However, in no event would a deduction be allowed for any amount in excess of twice the basis of the property.

For example, if a manufacturer makes a qualifying contribution to a high school of a computer with a cost basis of \$5X, and a fair market value of \$16X, the bill would allow the manufacturer a charitable deduction of \$10X (twice the \$5X basis). Assuming a 46 percent tax bracket, the effect of the deduction under the bill would be to reduce the manufacturer's tax liability by \$4.6X, or 92 percent of the cost of manufacture. The out-of-pocket cost of the donation to the manufacturer, exclusive of distribution and other expenses, would then be \$0.4X, or 8 percent of the manufacturer's cost. If in the example the fair market value of the computer was \$11X, the deduction would be \$8X (\$5X basis plus ½ of the \$6X difference between value and basis), and the out-of-pocket cost to the manufacturer would be \$1.32X (\$5X cost less \$3.68X tax benefit).

Increased overall limitation

The bill also would provide that the limitation on the aggregate charitable contribution deduction allowed to a corporation (under present law, 10 percent of taxable income, computed with certain adjust-

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[6] Unlike the special deduction rule of present law for qualifying contributions to colleges or universities of scientific research equipment (sec. 170(e)(4)), the rule provided under the bill would not require that the donated computer, etc., is constructed by the donor. For purposes of the present-law rule for scientific research equipment donations, property is to be treated as constructed by the taxpayer only if the cost of parts (other that parts manufactured by the taxpayer or a related person) used in construction do not exceed 50 percent of the taxpayer's basis in the property (sec. 170(e)(4)(C)).

[7] Where donated property is of a type which the taxpayer sells in the course of its business, the fair market value is the price which the taxpayer would have received if the taxpayer had sold the contributed property in the usual market in which it customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom it customarily sells, but if it sells only at retail the usual market consists of its retail customers (Reg. § 170A-1(c)(2)).

ments) would be increased by the amount of the taxpayer's qualifying contributions of computers or other sophisticated technological equipment. However, the limit as so increased could not exceed 30 percent of taxable income (as computed with certain adjustments).

Effective date

The provisions of the bill would apply to taxable years ending after the date of enactment. The special deduction rules provided under the bill would apply only to qualifying contributions which are made within one year after enactment.

Revenue effect

An estimate of the effect of the bill on budget receipts is not available at this time.

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