

[COMMITTEE PRINT]

DESCRIPTION OF H.R. 6715; TECHNICAL,  
CLERICAL AND CONFORMING AMENDMENTS  
OF THE TAX REFORM ACT OF 1976

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PREPARED FOR THE USE OF THE  
COMMITTEE ON WAYS AND MEANS  
BY THE STAFF OF THE  
JOINT COMMITTEE ON TAXATION



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## CONTENTS

|   | Page |
|---|------|
| I. Introduction-----  | 1    |
| II. Description of the bill-----  | 2    |
| A. Technical amendments to income tax and ad-<br>ministrative provisions (sec. 2 of the bill)-----          | 2    |
| B. Technical, clerical and conforming amendments to<br>estate and gift tax provisions (sec. 3 of the bill)- | 19   |
| C. Other clerical corrections, cross references, etc.<br>(sec. 4 of the bill)-----                          | 32   |
| III. Revenue effect-----  | 37   |



## **I. Introduction**

This pamphlet describes the technical revisions to the Tax Reform Act of 1976 (Public Law 94-455) contained in H.R. 6715.

The 1976 Act was one of the most extensive revisions to our present tax system. The technical amendments made by H.R. 6715 are intended to clarify and conform various provisions adopted by the 1976 Act. H.R. 6715 is based on a review by the staff of the Joint Committee on Taxation, taking into account the comments submitted to the Congress that were technical in nature. The bill was developed with assistance of the staffs of the Treasury Department and Internal Revenue Service.

Section II of this pamphlet is organized in three parts: Part A summarizes the technical amendments to income tax and administrative provisions; Part B summarizes the technical and conforming amendments to the estate and gift tax provisions; and Part C summarizes the clerical corrections and cross-reference changes. Section III discusses the overall revenue effect of the bill.

## II. DESCRIPTION OF THE BILL

### A. TECHNICAL AMENDMENTS TO INCOME TAX AND ADMINISTRATIVE PROVISIONS (SEC. 2 OF THE BILL)

#### 1. *Retirement Income Credit for Public Retirees Under Age 65 (sec. 2(a) of the bill and sec. 37 of the Code)*

Prior to the enactment of the Tax Reform Act of 1976, special rules were provided under which a taxpayer under age 65 was eligible for a retirement income credit if he or she had retired under a public retirement system. The 1976 Act continued this treatment. However, in the case of a married couple, the statute does not specifically require the spouse under age 65 to have public retirement system income in order to qualify for the election.

The bill would make it clear that, in the case of a married couple, the spouse under age 65 must have public retirement income. The bill also makes it clear that the special rules for public retirement income apply only to a taxpayer who was an employee covered under the system and his spouse.

#### 2. *Special Rules for Minimum Tax In The Case of Subchapter S Corporations and Personal Holding Companies (sec. 2(b)(1) of the bill and secs. 57 and 58 of the Code)*

Under the minimum tax provisions, electing small business corporations (subchapter S corporations) and personal holding companies generally determined their tax preferences in a manner similar to individuals. The 1976 Act added a preference for individuals for excess itemized deductions, i.e., certain itemized deductions in excess of 60 percent of adjusted gross income.

The bill makes two technical changes to clarify the application of the minimum tax provisions to subchapter S corporations and personal holding companies. The bill clarifies that the preference for excess itemized deductions does not apply to subchapter S corporations and personal holding companies since these corporations have no adjusted gross income from which to calculate preferences. In addition, a change is made to clarify that the capital gains preference for a personal holding company is to be determined under the rules applicable to corporations rather than the rules applicable to individuals.

#### 3. *Exemption for Controlled Groups for Purposes of the Minimum Tax (sec. 2(b)(2) of the bill and sec. 58 of the Code)*

Prior to the 1976 Act, generally a corporation's minimum tax exemption was \$30,000 plus the amount of income taxes otherwise imposed (the regular tax deduction). In the case of a controlled group, the exemption was allocated among the members of the group equally or according to a plan adopted by the members of the group. The 1976 Act changed the exemption for corporations to the greater of \$10,000 or their regular tax deduction, but did not change the manner in which the exemption could be apportioned in the case of a controlled group.

The bill would require the allocation of the \$10,000 exemption in proportion to each member's regular tax deduction.

**4. *Minimum Tax Imposed on Trusts and Estates (secs. 2(b)(3), (4), and (5) of the bill and secs. 57 and 58 of the Code)***

The bill clarifies in several respects the treatment of trusts and estates under the minimum tax in the case of the preference for excess itemized deductions. First, the bill makes it clear that the concept of "adjusted gross income" applies to trusts and estates in basically the same manner as to individuals. Second, the bill clarifies that the personal exemption is not counted in determining the excess itemized deductions. Third, the bill provides that the deduction for administration expenses and, in the case of estates and wholly charitable trusts, the deductions for charitable contributions are treated as deductions in determining adjusted gross income. Finally, the bill provides the Internal Revenue Service with broader authority to allocate preferences between the trustor estate and its beneficiaries.

In addition, the bill provides that the deduction for estate taxes attributable to income in respect of a decedent is not counted in computing the preference for excess itemized deductions for individuals as well as trusts and estates.

**5. *Sick Pay Exclusion (sec. 2(c) of the bill and sec. 105 of the Code)***

Under the 1976 Act, the sick pay exclusion is reduced on a dollar-for-dollar basis for adjusted gross income in excess of \$15,000. The provision also requires married couples claiming the exclusion to file joint returns. However, it is not clear whether the phaseout is made separately on the basis of each spouse's adjusted gross income or on their combined income or whether, if otherwise eligible, both spouses are entitled to one or two maximum exclusions of \$5,200.

The bill clarifies that an eligible married couple may claim a maximum exclusion of \$5,200 each (a total of \$10,400) but are together subject to a phaseout above \$15,000 of their adjusted gross income.

**6. *Net Operating Loss Carryback and Carryforward (sec. 2(d) of the bill and sec. 172 of the Code)***

Under the 1976 Act, the carryover period was increased by two years for net operating losses of several categories of business taxpayers. The categories of taxpayers which received the two additional carryover years were business taxpayers in general and insurance companies, both of which previously had 3-year carryback and 5-year carryover periods for their losses, and regulated transportation corporations which previously had 3-year carryback and 7-year carryover periods for their net operating losses. The two additional carryover years were not extended to categories of taxpayers which already had lengthy periods to absorb their losses, such as financial institutions which are allowed 10-year carryback and 5-year carryover periods.

However, under the 1976 Act, the two additional carryover years were inadvertently extended to Banks for Cooperatives, which, like other financial institutions, could already carry their net operating losses back for 10 years and forward for 5 years. The bill corrects this oversight to provide Banks for Cooperatives with the same treatment accorded other financial institutions.

**7. Construction Period Interest and Taxes (sec. 2(e) of the bill and sec. 189 of the Code)**

The 1976 Act added a new provision (sec. 189) requiring the capitalization and amortization of real property construction period interest and taxes. In the case of nonresidential real estate, the new provisions apply where the construction period begins after December 31, 1975. However, no provision for an amortization deduction was provided with respect to construction beginning in 1976 for a taxpayer whose taxable year began in 1975.

The bill clarifies that capitalization and amortization of construction period interest and taxes for nonresidential property is required only if the construction period begins on or after the first day of the first taxable year beginning after December 31, 1975.

**8. Tax Treatment of Certified Historic Structures (sec. 2(f) of the bill and secs. 167, 191, and 280B of the Code)**

Under the 1976 Act provisions dealing with historic structures, taxpayers are allowed to amortize over 5 years the expenses incurred in rehabilitating certified historic structures or, alternatively, to depreciate substantially rehabilitated historic structures using accelerated depreciation methods. The Act also prohibits deductions with respect to the demolition of certified historic structures and requires straight-line depreciation on any replacement structure. Under the Act, a certified historic structure is defined as a depreciable structure listed in the National Register, a depreciable structure located in a district listed on the National Register if the Secretary of the Interior certifies that the structure is of historic significance to the district, or a depreciable structure located in a State or locally designated historic district which meets certain tests.

Under the definition contained in the 1976 Act, there is no requirement that State or locally designated districts satisfy the criteria for a listing on the National Register or that structures be of historic significance to the districts. The bill conforms the definition with respect to structures located in State or locally designated districts with the rules applicable to Federally designated districts, by providing that structures in these districts are certified historic structures only where the district substantially satisfies the criteria for listing in the National Register and the Secretary of the Interior certifies that the structure is of historic significance to the district.

The 1976 Act contains a special rule under which deductions are not allowed with respect to the demolition of a structure located in a registered historic district unless the Secretary of Interior certifies that the building is not of historic significance. The bill applies this special rule to structures located in State or locally designated districts. The bill also provides a similar requirement that, in order to obtain accelerated depreciation on a structure replacing a demolished structure which was located in a Federal, State, or locally designated historic district, certification that the structure to be demolished is not historically significant must be obtained prior to its demolition (the provisions of the Act applicable to State and locally designated districts require straight line depreciation even if the replaced structure was not of historic significance).

The 1976 Act provides that the full amount of the rapid amortization deductions claimed are to be recaptured on the sale or exchange



of an historic structure (i.e., gain on the disposition, to the extent of the rapid amortization claimed, is treated as ordinary income rather than capital gain). This is the rule that generally applies with respect to recapture of depreciation or amortization deductions on dispositions of personal property. However, in the case of the disposition of real property, recapture is ordinarily limited to the extent that the depreciation or amortization deductions claimed exceed otherwise allowable straight line depreciation. The bill applies the real property recapture rules to rapid amortization of certified rehabilitation expenditures; that is, recapture is generally limited to the excess of the amortization claimed over otherwise allowable straight line depreciation.

**9. Foreign Conventions (sec. 2(g) of the bill and 274 of the Code)**

The 1976 Act added new provisions limiting the deduction for attendance at a foreign convention. One of the provisions limits the deductibility of the full transportation expenses to and from the site of the convention to situations where "more than one-half" of the total days of the trip (exclusive of days travelling to and from the convention) are devoted to business activities. If "less than one-half" of the total days are devoted to business activities, the transportation expenses are allocated to business activities on the basis of the percentage of days devoted to business. No specific rule is prescribed when exactly one-half of the time is devoted to business.

The bill makes it clear that a portion of the transportation expense will be denied only where less than one-half of the total days are devoted to business activities.

**10. Simultaneous Liquidation of Parent and Subsidiary Corporations (sec. 2(h) of the bill and sec. 337 of the Code)**

The 1976 Act extended the rule for 12-month liquidations under section 337 (a single tax at the shareholder level on the proceeds of an asset sale by a liquidating corporation) to a sale by a member of an affiliated group of corporations, if every other member of the group which receives a liquidating distribution also liquidates completely. The 1976 Act, however, did not limit the benefit of this new rule so that it would not apply where the parent (or common parent) corporation is liquidated taxfree (in whole or part) under the one-month liquidation rule of section 333 of the Code. (Under section 333 a shareholder's gain is taxable only to the extent the corporation has accumulated earnings and profits or distributes money and stocks or securities acquired after 1953). If both liquidation provisions could apply to an asset sale followed by liquidation, the result in many cases would be that no current tax would be imposed on the sale proceeds. The bill makes the rule added by the 1976 Act inapplicable where the parent (or common parent) is liquidated under the one-month liquidation rule of section 333. The amendment made by the bill also makes clear that the relief extended to simultaneous liquidations was not intended to cover section 333 liquidations of subsidiaries.

The bill also provides rules to deal with changes in stock ownership of the selling company after it adopts a liquidation plan or sells its assets and before it makes liquidating distributions. The bill makes it clear that if the selling company is a member of an affiliated group at the time it makes liquidating distributions, each corporate member of the group at that time which receives a distribution must liquidate in order for the benefit of the rule to be obtained. Also, even if a corpora-

tion which receives a liquidating distribution was not a member of the affiliated group at the time the selling company liquidated, the recipient corporation must also liquidate completely within the 12-month period specified in the statute.

**11. Exchange Funds (sec. 2(i) of the bill and sec. 368 of the Code)**

Under present law, as amended by the 1976 Act, a realized loss can be created and deducted if it results from the merger of two or more commonly-controlled investment companies, unless the combining companies are owned by substantially the same persons in the same proportions. In order to carry out more effectively the policy against allowing artificial losses, the bill provides that a loss resulting from a merger of two investment companies will not be recognized even though, under the rule adopted by the 1976 Act, the transaction would be treated as a sale or exchange rather than as a tax-free reorganization.

In addition, the bill conforms the definition of an investment company to parallel the approach taken in defining a diversified portfolio and adds the special definition of the term "securities." Finally, the bill makes several changes in the language of the "reverse acquisition" rule in order to clarify the computation of the amount which shareholders will be deemed to realize in transactions to which this special rule applies.

**12. At Risk Provisions (sec. 2(j) of the bill and sec. 465 of the Code)**

The 1976 Act contains a special effective date provision for application of the at risk provision to equipment leasing activities. The bill amends this provision by correcting a clerical error in a cross reference which had referred to a provision describing farming activities and which should have referred to leasing activities.

In addition, this at risk provision (sec. 465) provides generally that the amount of any loss (otherwise allowable for the taxable year) which may be deducted in connection with any one of certain activities (involving farming, oil and gas, motion pictures or video tapes, or equipment leasing) cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. The intent of the provision is to treat amounts disallowed by reason of the at risk provision in the prior taxable year in the same manner as amounts paid or accrued in the current taxable year.

The definition of loss for a taxable year (sec. 465(d)) refers to the excess of the deductions allowable for the taxable year (determined without regard to the at risk provision) over the income received or accrued by the taxpayer during the taxable year from the activity. The bill amends this definition of loss to clarify that the deductions entering into the computation of the loss for the current year include losses from prior years which by virtue of section 465(a) are treated as deductions in the current year.

**13. Extensions of Certain Provisions to Foreign Personal Holding Companies (sec. 2(k) of the bill and secs. 189, 280, and 465 of the Code)**

The 1976 Act contained a number of provisions to limit taxpayers' use of tax shelters. One of these provisions provides that certain

real property construction period interest and taxes are to be capitalized in the year in which they are paid or accrued and amortized over a period of years, generally 10 years (sec. 189). Another section provides that the amount of any loss (otherwise allowable for the year) which may be deducted in connection with any one of certain activities (involving farming, oil and gas resources, motion picture, films or video tapes, or equipment leasing) cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each activity at the close of the taxable year (sec. 465). A third section requires the capitalization of the costs of producing motion pictures, books, records, and other similar property and permits the deduction of these capitalized costs over the life of the production activity (sec. 280). All of these provisions apply to individuals, estates, trusts, subchapter S corporations and personal holding companies. These provisions do not apply to other corporations.

In general, these provisions were applied only to situations where the deductions would reduce the taxable income of individuals (or estates and trusts). However, these rules were also made applicable to personal holding companies which are certain domestic corporations established to receive and hold investment income or compensation of its shareholders in order to shield that income from the higher individual tax rates that would apply if the income were received by the shareholders.

Since a foreign personal holding company can be utilized in generally the same manner as a personal holding company to shelter income from the individual income tax rates and it was the intention of Congress to prevent the sheltering of income which should be subject to the individual income tax rates by use of these deductions, the bill also applies the three tax shelter provisions discussed above to foreign personal holding companies.

**14. Definition of Condominium Management Association (sec. 2(l) of the bill and sec. 528 of the Code)**

The Tax Reform Act of 1976 added a provision to the Code which permits certain homeowners associations to elect to be treated as tax-exempt with respect to their exempt function income. The homeowners associations which are eligible to make this election include condominium management associations and residential real estate management associations which satisfy certain standards. Under the 1976 Act, the definition of residential real estate management association requires that substantially all of the lots or buildings of the subdivision, development, or similar area which the association serves "may only be used by individuals for residences", but the similar requirement for condominium management associations is that substantially all of the units of the condominium project be "used as residences."

The bill conforms the requirement for condominium management associations to that for residential real estate management associations in order to make it clear that no distinction was intended in this respect.

**15. Property Transferred to Trust at Less Than Fair Market Value (sec. 2(m) of the bill and sec. 644 of the Code)**

The bill clarifies the treatment of installment sales under the provision of the 1976 Act which taxes gains realized by a trust within 2

years of the contribution of the property to the trust at the grantor's income tax rate brackets. Under the amendment, each installment is taxed at the grantor's rate brackets if the installment sale occurred within the 2-year period. The bill also removes a conforming amendment in the capital gain throwback rules which were repealed by the 1976 Act, since the 1976 Act's revision of section 644 removed the need for such a conforming amendment.

**16. Allowance of Foreign Tax Credit for Accumulation Distributions (sec. 2(n) of the bill and secs. 665 and 667 of the Code)**

Distributions from trusts of previously accumulated income are taxed in substantially the same manner as if the income were distributed when earned. The 1976 Act makes several modifications in the manner in which accumulation distributions are taxed. Under the Act accumulation distributions are thrown back to three of the five preceding years, excluding those years with the highest and lowest incomes, and are taxed at the beneficiary's rates for those years with a credit for any taxes paid by the trust. The Act does not permit refunds of excess taxes paid by the trust. In addition, the accumulation distributions generally do not retain, in the hands of the beneficiary, the character of the income from which they were distributed.

The modifications made by the 1976 Act to the taxation of accumulation distributions leave unclear whether beneficiaries may claim the foreign tax credit with respect to foreign taxes paid by the trust which are allocable to accumulation distributions and, if a foreign tax credit is allowed, how it is computed. The bill provides rules under which beneficiaries may claim the foreign tax credit with respect to foreign taxes allocable to accumulation distributions.

In general, a beneficiary is allowed a credit against the additional tax imposed on an accumulation distribution for the taxes imposed on the trust allocable to the accumulated income distributed to him. The bill amends the definition of taxes imposed on the trust (sec. 665(d)) by providing that in the case of domestic trusts, this term includes foreign taxes as well as U.S. taxes which are allocable to the trust's accumulated income, with the result that the foreign taxes may be credited against the beneficiary's additional tax on the accumulation distribution. However, the foreign taxes taken into account are only those foreign taxes which are allowed as foreign tax credits to the trust for the relevant years after applying the foreign tax credit limitation provisions (sections 904 and 907). Foreign taxes which exceed the limitation for any year, or foreign taxes that were deducted by the trust for any year, will not be considered taxes imposed upon the trust.

A separate rule is provided under which the foreign tax credit is allowed with respect to accumulation distributions from foreign trusts. Under this rule, foreign taxes paid by a foreign trust which are allocable to accumulation distributions are generally treated as paid or accrued by the beneficiary in the taxable year for which the distribution is includible in his income. Thus, the beneficiary will gross up the amount of the distribution by the amount of taxes deemed paid or accrued and will be allowed to treat the taxes as credits against the additional U.S. tax on the accumulation distribution. However, the amount of foreign taxes paid by a foreign trust which

are treated as paid by the beneficiary cannot exceed the foreign tax credit limitation (sections 904 and 907) computed separately with respect to the beneficiary's distribution from that foreign trust. To the extent necessary to apply the foreign tax credit limitations with respect to accumulation distributions to the beneficiary, the items of income, deductions, and credits of the trust will retain their character and source.

**17. Limitation on Allowance of Partnership Losses in the Case of Nonrecourse Loans (sec. 2(o) of the bill and sec. 704(d) of the Code)**

The 1976 Act provided that, in general, for purposes of the limitation on allowance of partnership losses, the adjusted basis of a partner's interest will not include any portion of any partnership liability with respect to which the partner has no personal liability. However, two exceptions to this rule were provided. Under the first exception, the rule did not apply with respect to any activity to the extent that the specific at risk rule applied. Under the second exception, the rule did not apply to "any partnership the principal activity of which is investing in real property (other than mineral property)." This second exception has created considerable difficulty because of ambiguities in the terms "investing" and "principal activity".

The bill clarifies these ambiguities by providing that, for a partnership to qualify for this exception, substantially all of the activities of the partnership must relate to the holding of real property (other than mineral property) for sale or rental. This amendment also makes it clear that active as well as passive rental operations are excepted.

**18. Annual Accounting Period of a Real Estate Investment Trust (sec. 2(p)(1) of the bill and sec. 860 of the Code)**

The 1976 Act provides that a real estate investment trust (REIT) cannot adopt or change to a taxable year other than the calendar year. However, that provision did not specifically require a newly electing REIT to adopt a calendar year if it had previously adopted a fiscal taxable year. The bill provides that a REIT must adopt the calendar year in order to be eligible to elect REIT status. However, this rule does not apply to any REIT which had qualified for REIT status on or before October 4, 1976.

**19. Clarification of Status of REIT Shares Held Primarily for Sale (sec. 2(p)(2) of the bill and sec. 856(c)(3)(D) of the Code)**

Prior to the 1976 Act, a real estate investment trust (REIT) could not hold any property primarily for sale. The 1976 Act permitted REITs to hold property primarily for sale, but imposed a 100-percent tax on the income from such property. Also under the 1976 Act, gain derived from property held for sale generally does not qualify for purposes of meeting the income source tests applicable to REITs. However, it was possible under the 1976 Act for gain derived from shares in another REIT to qualify for the 75-percent income source test even though the shares were held primarily for sale. The bill clarifies that for purposes of the 75-percent income source test qualifying income does not include gain from the sale of REIT shares which were held primarily for sale.

**20. Excise Tax on REIT Undistributed Income (sec. 2(p)(3) of the bill and sec. 6501(e) of the Code)**

The 1976 Act imposed an excise tax on a real estate investment trust (REIT) that does not distribute at least 75 percent of its REIT taxable income during its taxable year. The bill corrects three incorrect or omitted references to this excise tax in the Internal Revenue Code and in the 1976 Act.

**21. Correction of Cross Reference to Section 6601(b) (sec. 2(p)(4) of the bill and sec. 859(b)(2) of the Code)**

The bill corrects an inaccurate cross reference in the provisions of the 1976 Act relating to real estate investment trusts (sec. 859(b)(2)) to section 6601(b) of the Internal Revenue Code that arose because of a renumbering of that section by Public Law 93-625.

**22. Foreign Income Provisions (sec. 2(q) of the bill)**

**A. Taxation of possessions corporations (secs. 2(q)(1) and (9) of the bill and secs. 901(g)(1) and 936 of the Code)**

The 1976 Act restructures the taxation of U.S. corporations substantially all of whose operations are in Puerto Rico and the possessions ("possessions corporations"). In brief, the Act provides that possessions corporations are entitled to a tax credit equal to the U.S. tax which otherwise would be paid on the income derived from the active conduct of a trade or business in a possession or from investments in the possession of the earnings from a possessions business.

A recent Tax Court case (*Kewanee Oil Co.*, 62 T.C. 728) has held that the sale of substantially all the assets of a trade or business does not, for purposes of the Western Hemisphere trade corporation provisions, constitute income derived from the active conduct of a trade or business. The bill makes it clear that taxable income from the sale of substantially all the assets which had been used by a possessions corporation in the active conduct of a possessions business may qualify for the possessions tax credit. In addition, the bill provides that income from the sale or exchange by a possessions corporation of any asset will not qualify for the credit if the basis of the asset (for purposes of determining the gain on the sale or exchange) is determined in whole or in part by reference to its basis in the hands of another person, unless the other person was a possessions corporation.

In addition to the tax credit for income earned by possessions corporations, the 1976 Act provides that corporate shareholders are entitled to the dividends-received deduction with respect to dividends from possessions corporations. As a result, Congress decided that it was inappropriate to allow a foreign tax credit for taxes imposed on distributions from possessions corporations to U.S. shareholders which are also partially or fully exempt from U.S. tax because of the dividends-received deduction or other nonrecognition provisions. However, the Act (sec. 901(g)) disallows the credit even where the distribution was fully subject to U.S. tax. For example, the credit is denied with respect to withholding taxes on dividends from possessions corporations which are received by individuals although individuals are not entitled to the dividends-received deduction.

The bill provides that the denial of the foreign tax credit with respect to taxes imposed on distributions from possessions corporations does not apply where the distribution is fully taxable by the U.S. Where

the recipient of the distribution (including an indirect recipient such as a corporate partner of a partnership or corporate beneficiary of a trust which directly receives the dividend) is entitled to a dividends-received deduction attributable to the distribution, the credit is denied with respect to the full amount of the taxes imposed on the distribution. Where the distribution is received in connection with a liquidation or other transaction, the credit is denied to the extent that the taxes are imposed on gain or loss which is not recognized for U.S. tax purposes by the recipient.

*B. Foreign tax credit adjustments for capital gains (secs. 2 (g) (2) and (3) of the bill and sec. 904 of the Code)*

The 1976 Act made several adjustments to the computation of the foreign tax credit to take account of the fact that capital gains are taxed differently from ordinary income. Code section 904(b)(2), added by section 1031 of the Act, establishes the rules for determining the manner in which income and loss from the sale of capital assets is taken into account in computing the credit. However, the provision applies those adjustments only for the computation of the limitation itself and not for other purposes.

The bill provides that the adjustments with respect to capital gains and losses apply for all foreign tax credit limitation purposes (i.e., sec. 904) so that the adjustments are applicable for loss recapture purposes. In addition, the bill amends clause (iii) of section 904(b)(2)(A) to make it clear that the three-eighths reduction provided with respect to foreign capital losses which offset U.S. source net capital gains is made only in computing the numerator of the limiting fraction and to provide that the adjustment is also made where the foreign capital loss is a capital loss carried from a preceding or succeeding taxable year.

*C. Treatment of capital loss carryovers and carrybacks for recapture purposes (sec. 2(g)(4) of the bill and sec. 904 of the Code)*

The 1976 Act provides that where a taxpayer has an overall foreign loss (or a foreign oil related loss) in one year, that loss is to be recaptured by recharacterizing foreign source income (or foreign oil related income) earned in future years as U.S. source income for foreign tax credit limitation purposes. An overall foreign loss is the amount by which foreign source income is exceeded by the deductions attributable thereto; a foreign oil related loss is the amount by which foreign oil related income is exceeded by deductions attributable thereto. Since foreign losses carried to other years are included in the computation of the overall foreign loss or foreign oil related loss in the year sustained for recapture purposes, net operating losses are excluded from the computation of any overall foreign loss or foreign oil related loss for the year to which carried in order to prevent a double counting of the loss.

The Act similarly excludes capital loss carrybacks and carryovers from overall foreign loss and foreign oil related loss. However, since capital losses are deductible only to the extent of capital gains (plus a limited amount allowed to offset ordinary income of individuals under sec. 1211(b)), foreign capital losses which are not deductible in the year incurred are not included in overall foreign loss or foreign oil related loss in either the year sustained or the year to which carried; thus, they are not subject to recapture.

The bill amends the definition of overall foreign losses and foreign oil related losses to eliminate the restriction against including capital loss carryovers and carrybacks. Thus, such losses will be subject to recapture to the extent they are used as carryovers or carrybacks in years in which the taxpayer has an overall foreign loss or a foreign oil related loss.

*D. Effective date of recapture of foreign oil related losses (sec. 2(q)(5) of the bill and sec. 904 of the Code)*

The provisions requiring recapture of foreign oil related losses were added to the Code by the Tax Reduction Act of 1975. The provisions applied to losses sustained in taxable years ending after December 31, 1975. The 1976 Act modifies the rules relating to recapture of foreign oil related losses and extends recapture to all foreign losses. The modifications to the foreign oil related loss recapture rules were intended to apply retroactively to the effective date of those rules under the Tax Reduction Act. However, the effective date of the 1976 Act modifications is taxable years beginning after December 31, 1975, rather than taxable years ending after December 31, 1975 (the effective date of the oil related loss recapture rules under the Tax Reduction Act). This amendment provides that the modifications dealing with recapture of foreign oil related income made by the 1976 Act apply to taxable years ending after December 31, 1975.

*E. Transitional per-country rules for certain mining companies and income from possessions (sec. (2)(q)(6) of the bill and sec. 904 of the Code)*

Under the 1976 Act, the per-country limitation may continue to be used by certain mining companies with respect to foreign mining income and by all taxpayers with respect to income from possessions for a 3-year transitional period (taxable years beginning before January 1, 1979). The transitional rule provides also that any losses sustained by the mining companies and any possessions source losses would be recaptured on a per-country basis against income subsequently earned in the country or possession where the loss was sustained. However, the transitional rule as drafted would require losses sustained by all qualifying mining companies during the 3-year transition period to be recaptured on a per-country basis even in those cases where, with respect to the year of the loss, the taxpayer elects to use the overall limitation rather than the transitional per-country limitation. Similarly, the transitional rule requires all possessions source losses sustained during the transition period to be recaptured on a per-country basis against future possessions source income, even where the taxpayer has elected not to use the transitional per-country limitation. The bill amends the transitional rule so that foreign mining losses and possessions source losses sustained during the transition period will be recaptured on a per-country basis only if the transitional per-country limitation applied to the year in which the loss is sustained.

*F. Limitation on credits for foreign taxes on oil and gas extraction income earned by individuals (sec. 2(q)(7) of the bill and sec. 907 of the Code)*

The 1976 Act made several modifications with respect to the limitations on credits for foreign taxes paid on oil and gas extraction income. In the case of corporations, the limitation on extraction taxes



was reduced to 48 percent, the maximum tax which the U.S. would impose on such income. However, in the case of noncorporate taxpayers, it was felt that the 48-percent limitation was not appropriate because foreign extraction taxes should be allowed as creditable taxes to the extent of the effective U.S. tax rate on the extraction income, and noncorporate taxpayers could be subject to U.S. tax on that income at average rates in excess of the corporate rates.

The change in the extraction limit in the case of noncorporate taxpayers was accomplished by eliminating the separate limitation for oil related income of noncorporate taxpayers and the fixed percentage limitation on their extraction taxes and by substituting a separate foreign tax credit limitation for foreign oil and gas extraction income. Thus, the limitation on extraction taxes paid by noncorporate taxpayers is an amount equal to the taxpayer's effective U.S. rate of tax (before foreign tax credit) times the taxpayer's foreign extraction income.

Although this change effectively accomplishes the intended goal of allowing credits for extraction taxes paid by noncorporate taxpayers up to the amount of the pre-credit U.S. tax on the extraction income, it also has certain unintended additional effects. First, the change operates to allow noncorporate taxpayers full carrybacks and carryovers of all excess extraction taxes, rather than limiting the excess credits which can be carried from a year to 2 percent of extraction income (as in the case of corporations). In addition, it allows noncorporate taxpayers to use extraction losses arising in a country to reduce foreign income which is not oil related and then to reduce U.S. source income, rather than requiring that such losses first reduce foreign oil related income earned in other countries.

The bill retains as the limit on credits for extraction taxes paid by noncorporate taxpayers their pre-credit U.S. tax on extraction income, but it also conforms the treatment of extraction taxes for noncorporate taxpayers to the treatment afforded corporate taxpayers by imposing the separate limitation for foreign oil related income and limiting the excess credits which can be carried from a year to 2 percent of extraction income.

*G. Foreign taxes attributable to section 911 exclusion (sec. 2(q)(8) of the bill and sec. 911 of the Code)*

One of the several modifications to the earned income exclusion for U.S. citizens working abroad made by the 1976 Act was the disallowance as a credit or deduction of those foreign taxes attributable to the excluded income. The Act, however, does not indicate how the taxes attributable to the excluded amount should be determined. This amendment specifies the manner in which the amount of disallowed taxes is determined. The amount of foreign taxes disallowed is determined by multiplying the amount of the foreign taxes paid by a fraction the numerator of which is the U.S. tax on the excluded amount and the denominator of which is the sum of the tax on the excluded amount plus the foreign tax credit limitation for the year. Under this method, taxes are generally disallowed in the proportion that the tax on the excluded amount bears to the amount of U.S. tax which would be imposed on an amount of taxable income equal to foreign source income (thereby allocating foreign taxes between excluded and nonexcluded foreign source income in proportion to the U.S. progressive tax rate schedule). Where a taxpayer has U.S. source

income, the amount of taxes disallowed is somewhat less because the average U.S. effective rate is applied to the nonexcluded foreign source income. However, this method greatly simplifies the calculation because it uses figures that are line items on the return which the taxpayer must compute in any event for other purposes.

*H. Gain on disposition of stock in a DISC (sec. 2(q)(10) of the bill and sec. 995(c)(1)(C) of the Code)*

Prior to the 1976 Act, there was no recapture of accumulated DISC income (i.e., treatment as a dividend) on the distribution of DISC stock in certain tax-free transactions (sec. 311, 336, or 337) because no gain was recognized on the transfer. The accumulated DISC income would also escape recapture upon a subsequent disposition of the DISC stock by the distributee if the distributee did not carryover the distributing corporation's basis and holding period in the DISC stock (but instead received a stepped-up basis). Therefore, the 1976 Act requires recapture of the accumulated DISC income upon a distribution, sale, or exchange of DISC stock to which section 311, 336, or 337 of the Code applies. (Sec. 995(c)(1)(C).)

However, in certain transactions to which section 311, 336, or 337 applies where the stock of a DISC is transferred from one member to another member of the same controlled group, the distributee does not receive a step-up in basis for the distributed stock, but rather receives a carryover basis. Moreover, in those instances where the distributee receives a carryover basis, the holding period of the distributor is tacked on to the holding period of the distributee (sec. 1223(2)). Because there is a carryover of basis and holding period in these situations, there is no possibility for the avoidance of the recognition of accumulated DISC income upon the subsequent disposition of such stock by the distributee.

The bill would make the 1976 Act amendment inapplicable to those situations where the distributee of the DISC stock receives both a carryover basis and a tacked on holding period. Thus, for example, in a liquidation of a subsidiary to which section 334(b)(1) applies (in which the basis and the holding period of property distributed by a subsidiary is carried over to its parent), recapture on the distribution of DISC stock would not be required.

*I. Limitation on partner's tax where partner is treated as having sold or exchanged section 1248 stock (sec. 2(q)(11) of the bill and sec. 751 of the Code)*

The 1976 Act provides that if a partnership holds stock in a foreign corporation which would be subject to dividend treatment (under sec. 1248) if sold or exchanged, any gains to a partner receiving certain partnership distributions or selling his interest in the partnership will be treated as a dividend to the extent that he would have had a dividend had the foreign corporate stock been sold. However, the dividend treatment rules on foreign corporate stock include a specific limitation applicable to individuals (sec. 1248(b)) under which the individual's U.S. tax is limited to (1) his share of any additional tax that would have been payable if the foreign corporation had been a domestic corporation paying tax at the full United States corporate rate plus (2) the capital gains tax which the individual would be liable for on an amount equal to his share of the after-tax earnings and profits (assuming the full U.S. tax rate) of the corporation. The provision in the

1976 Act applying the dividend treatment rules to the partnership area did not include this special limitation relating to individuals.

The bill adds a new partnership provision (section 751(e)) under which the limitation on dividend treatment is applied with respect to individual partners.

*J. Transfer of property to foreign persons not subject to section 1491 excise tax (sec. 2(g)(12) of the bill and sec. 1492 of the Code)*

The 1976 Act provides that the excise tax imposed on transfers of property to foreign persons to avoid Federal income tax (sec. 1491) shall not apply to "a transfer to which section 367 applies". In these instances, the taxation of such transfers will be governed by section 367. Section 367(a)(2) provides, in effect, that section 367 will not apply to any exchange or to any type of property designated by the Secretary in regulations. Consequently, by virtue of section 367(a)(2), there will be certain exchanges and types of properties to which section 367 will not apply and thus will not be within the scope of the exception to the section 1491 excise tax. The bill provides that the excise tax does not apply to "a transfer described in section 367." As a result of this amendment, transfers of property described in section 367, although excepted from its application under section 367(a)(2), will not be subject to the excise tax imposed under section 1491.

*K. Income tax treatment of nonresident alien individuals who are married to citizens or residents of the United States (sec. 2(g)(13) and (14) of the bill and sec. 6013(g) of the Code)*

The 1976 Act permits a nonresident alien individual who is married to a citizen or resident of the United States to file a joint return provided that both spouses elect to be taxed on their worldwide income. Section 6013(g)(1) provides, in part, that the nonresident alien individual in question "shall be treated as a resident of the United States for purposes of chapter 1 for all of such taxable year." By referring only to chapter 1 of the Code, a nonresident alien qualifying under section 6013(g) will be treated as a U.S. resident for joint return purposes, but as a nonresident alien for purposes of the excise tax on transfers of property to a foreign person (chapter 5) and for wage withholding purposes (chapter 24).

The bill provides that nonresident aliens will be treated as U.S. residents for purposes of chapters 5 and 24, as well as chapter 1. It is contemplated that nonresident aliens electing under section 6013(g) will be treated as resident aliens under the procedural and administrative provisions of Subtitle F where those provisions relate to the treatment of the taxpayer under chapter 1, 5, or 24. In addition, the bill provides that a refund will be allowed for any overpayment of tax attributable to withholding taxes imposed (under sec. 1441) on income of an electing nonresident alien for a year with respect to which the election applies.

In addition, the Act provides that the election to be treated as a resident will apply to any individual who, at the time an election was made, was a nonresident alien individual married to a citizen or resident of the United States. A literal reading of this provision results in a timing requirement that, at the time the election is made, one

of the spouses must be a nonresident alien married to a U.S. citizen or resident. The amendment deletes the requirement that one spouse be a nonresident alien married to a U.S. citizen or resident at the time of the election and provides instead that it applies to nonresident aliens who, at the close of the taxable year with respect to which an election is made, are married to U.S. citizens or residents.

**23. *Gain from Sales Between Related Persons (sec. 2(r) of the bill and sec. 1239(a) of the Code)***

Under present law, gain from sales or exchanges between certain related persons is treated as ordinary income. The 1976 Act broadened the application of this provision (sec. 1239) to include sales or exchanges between commonly-controlled corporations and to determine ownership of stock by reference to the attribution rules generally applicable to corporations and shareholders (sec. 318).

In making these changes, the 1976 Act inadvertently changed the description of the property subject to the provision from "property of a character which is subject to the allowance for depreciation provided in section 167" to property which is "subject to the allowance for depreciation provided in section 167."

However, no substantive change was intended by this change in language. In order to prevent the possibility of any misinterpretation, the bill reinstates the language previously used.

**24. *Recapture of Depreciation on Player Contracts (sec. 2(s) of the bill and sec. 1245 of the Code)***

The 1976 Act provides special rules for the computation of the amount of recapture of depreciation in the case of player contracts. One of the limitations on the amount recaptured is determined by reference to the depreciation on player contracts involved in the transfer of a franchise reduced by the recapture on a prior disposition of the contracts.

Since there could be no prior dispositions of player contracts involved in a current transfer, the bill would delete the reduction for amounts recaptured as ordinary income for a previous disposition.

**25. *Treatment of Pensions and Annuities for Purposes of Maximum Tax on Personal Service Income (sec. 2(t) of the bill and sec. 1348 of the Code)***

The 1976 Act amended the 50-percent maximum tax on personal service income to provide, in part, that amounts received as a pension or annuity were treated as personal service income (subject to certain special exceptions). The provision did not specifically limit the application of the maximum tax to pensions or annuities which were connected with earned income from personal services.

A change is made to clarify that the maximum tax rate on amounts received as a pension or annuity is to apply only when the pension or annuity arises from a situation where personal services were rendered either as an employee or as a self-employed person. It applies to pensions and annuities established by an employer for his employees (whether or not under a qualified pension plan) and to amounts received from H.R. 10 plans and individual retirement accounts and annuities and retirement bonds.

**26. *Certain Grantor Trusts Treated as Permitted Shareholders of Subchapter S Corporations (sec. 2(u) of the bill and sec. 1371 of the Code)***

Prior to the 1976 Act, a corporation could not elect to be treated as a subchapter S corporation if it had a trust as a shareholder. Under the Tax Reform Act, a so-called "grantor trust" is permitted to be a shareholder of a subchapter S corporation. In addition, the 1976 Act permitted a testamentary trust to be a shareholder in a subchapter S corporation for 60 days. However, this rule was not extended to a grantor trust following the grantor's death although, in many cases, the trust is used as a will substitute.

The bill would amend the qualification requirements for subchapter S treatment to permit a grantor trust to be an eligible shareholder for a 60-day period following the grantor's death. The bill also makes it clear that a grantor trust is an eligible shareholder only if the grantor would be an eligible shareholder, i.e., an individual citizen or resident of the United States.

**27. *Withdrawals from Individual Retirement Accounts (sec. 2(v) of the bill and sec. 4973 of the Code)***

The Tax Reform Act of 1976 provided relief from the 6-percent excise tax for certain nondeductible contributions to individual retirement accounts (IRAs). Under the Act, contributions which are nondeductible because the IRA owner is an active participant in a tax-qualified pension plan are not subject to the excise tax if they are withdrawn by the time the tax return for the year is required to be filed.

The bill would change the language of this provision to clarify the circumstances under which the tax is not assessed, and to include a reference to spouse IRAs (sec. 220) which was inadvertently omitted from the Tax Reform Act of 1976.

**28. *Disclosure of Returns and Return Information (sec. 2(w) of the bill and sec. 6103 of the Code)***

Under present law, as amended by the 1976 Act, the Justice Department and other Federal agencies are required in nontax criminal cases to obtain court approval in order to receive return information which was filed by or on behalf of a taxpayer with the IRS. The court approval procedure, however, does not apply to return information which is not furnished by or on behalf of the taxpayer. Thus, in nontax criminal cases, the IRS may disclose to the Justice Department or other Federal agency, return information, other than that furnished by or on behalf of the taxpayer, including return information which may constitute evidence of a violation of the Federal criminal laws (secs. 6103 (i)(2) and (i)(3)).

In order for the IRS to transmit this information to the Justice Department or other Federal agency, it is necessary, of course, to provide the name and address of the taxpayer. Because the taxpayer furnishes his name and address on his return, it is arguable that the IRS would not be able to provide this information to the Justice Department or other Federal agency, thus, completely negating the purpose and operation of these provisions.

The bill would clarify this situation by providing that for purposes of these provisions (secs. 6103(i)(2) and (i)(3)), the name and address

of the taxpayer would not be considered "taxpayer return information". With this technical amendment, the IRS would have the authority to disclose to the Justice Department and other Federal agencies the name and address of a taxpayer along with information received from sources other than the taxpayer.

**29. *Definition of Income Tax Return Preparer (sec. 2(x) of the bill and sec. 7701 of the Code)***

The Tax Reform Act of 1976 expressly exempts a fiduciary of a trust or estate from certain rules relating to income tax return preparers for returns or claims for refund prepared for that trust or estate. However, other persons who prepare returns in a fiduciary capacity are not specifically excepted from the rules; for example, certain conservators or guardians whose fiduciary responsibilities are similar to those of trustees or executors.

The bill clarifies the provision so that the exception specifically applies to any person who prepares a return or claim for refund in a fiduciary capacity. To fall within the exception, the preparation of the return or claim for refund must be one of the fiduciary's responsibilities.

**B. TECHNICAL, CLERICAL AND CONFORMING AMENDMENTS TO ESTATE AND GIFT TAX PROVISIONS (SEC. 3 OF THE BILL)**

**1. *Fresh Start Adjustment for Certain Preferred Stock (sec. 3(a)(1) of the bill and sec. 306 of the Code)***

Under present law, special rules are provided to prevent the "bail-out" of dividends as capital gains upon a sale or redemption of preferred stock distributed to shareholders. Under these rules, the amount realized from a sale or redemption of certain preferred stock, known as "section 306 stock," is treated as dividend income. Prior to enactment of the carryover basis provisions of the 1976 Act, the dividend income treatment of the stock was eliminated when it passed from a decedent since the basis of the stock was "stepped-up" to fair market value at death. However, under the carryover basis rules, dividend income treatment for the amount realized (to the extent of a ratable portion of the corporation's earnings and profits) will apply to sales or redemptions of the preferred stock by the estate or heirs of the distributee shareholder.

The Act also provided for a "fresh start" adjustment to the basis of property held on December 31, 1976. However, the "fresh start" provision for carryover basis purposes will provide little, if any, relief for section 306 stock issued before 1977.

Since the fresh start rule was intended to continue prior law for appreciation occurring before January 1, 1977, the amendment would make it clear that dividend income only includes amounts received by the shareholder in excess of the stock's adjusted basis, including the fresh start basis adjustment, for section 306 stock which is carryover basis property distributed before January 1, 1977.

**2. *Redemptions of Certain Preferred Stock to Pay Death Taxes (sec. 3(a)(2) of the bill and sec. 303 of the Code)***

In certain cases, a distribution in redemption of stock to pay death taxes is treated as an amount realized from the sale or exchange of a capital asset rather than as dividend income. However, special rules are provided to prevent the "bail-out" of dividends as capital gains upon a sale or redemption of preferred stock distributed to shareholders known as "section 306 stock."

Under the carryover basis provisions added by the 1976 Act, this special rule applies to section 306 stock in the hands of the heirs of the distributee shareholder. As a result, it is presently unclear whether the provision extending capital gains treatment for redemptions to pay death taxes overrides the preferred stock bail-out provision in the case where section 306 stock is redeemed from the estate or heirs.

The bill would make it clear that capital gains treatment under the redemption provision is not generally available for section 306 stock. As under present law, an exception to this rule would apply to preferred stock received by a decedent's estate in a reorganization if the stock

is in substitution for common stock which was eligible for capital gains treatment in a redemption to pay death taxes.

**3. Deduction or Adjustment to Basis for Estate Tax on Appreciation (sec. 3(b) of the bill and sec. 691 of the Code)**

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for Federal and State death taxes attributable to appreciation. This adjustment is designed to prevent the imposition of an income tax on the portion of the estate taxes attributable to appreciation. Similarly, when property has been sold before death but the gain is recognized by the heirs for income tax purposes, the death taxes attributable to the gain are allowable as a separate deduction in computing the taxable income of the heirs (rather than as an adjustment to the basis of the property sold).

However, when the heir is entitled to preferential long-term capital gain treatment, there may be a substantial disparity of treatment for income tax purposes between gains recognized by the heirs for property sold before death by the decedent and gains realized by the heirs upon a subsequent sale of inherited property. The potential disparity of treatment depends on whether the estate tax adjustment is made in the form of a basis adjustment or a separate deduction.

The bill would eliminate any disparity of treatment by having the deduction for estate taxes attributable to income realized by a decedent, but recognized by the heirs, taken into account for capital gain purposes in the same manner as an adjustment to basis would be taken into account.

**4. Fresh Start Adjustment for Certain Carryover Basis Property (sec. 3(c)(1) of the bill and sec. 1023 of the Code)**

Under the carryover basis provisions added by the 1976 Act, a "fresh start" adjustment to the basis of inherited assets is permitted to reflect fair market value on December 31, 1976. This adjustment was intended to exclude appreciation occurring before 1977 from the carryover basis rule. However, to apply this fresh start rule, it is necessary to determine the property's basis immediately before death in order to measure the amount of appreciation occurring during the entire period a decedent had held the property. With respect to tangible personal property, it is particularly difficult to ascertain the fresh start adjustment in many cases because the executor or heirs may not be able to determine the basis of the property or even the approximate date on which the decedent had purchased the property.

The bill provides a formula to determine a minimum basis which reflects the fresh start adjustment. Under this formula, it would only be necessary to determine the value of the property at the decedent's death. The minimum basis would then be determined by discounting this value for an assumed rate of post-1976 appreciation. Under the formula, the post-1976 appreciation is assumed to accrue at approximately 8 percent a year.

**5. Treatment of Indebtedness Against Carryover Basis Property (sec. 3(c)(2) of the bill and sec. 1023 of the Code)**

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for the Federal and State death taxes attributable to appreciation. Generally, the adjustment is made by apportioning the death taxes to individual items of property on the



basis of the appreciation for that item as compared to the fair market value of all property included in the gross estate. In making this apportionment under present law, a nonrecourse debt against property is taken into account (1) as a reduction in the amount of appreciation in the particular property to which it applies and (2) as a reduction in the total fair market value of property of all property included in the gross estate. It has been argued that this rule may result in misallocating the death tax adjustment between property subject to a nonrecourse debt and other property.

The bill provides that nonrecourse debt is not to be taken into account as a reduction of either the appreciation of the property or the fair market value of the property includible in the gross estate for purposes of allocating the death tax adjustment between items of carryover basis property.

**6. Only One Fresh Start Adjustment for Carryover Basis Property (sec. 3(c)(3) of the bill and sec. 1023 of the Code)**

Under the carryover basis provisions added by the 1976 Act, a question has been raised as to the number of times a "fresh-start" basis adjustment may be made to carryover basis property when it is successively devised, bequeathed, or transferred by intestate succession by two or more decedents. In these cases, it has been argued that successive fresh-start basis adjustments may be made with respect to the property because the property will continue to have a basis which reflects, in part, the basis of the property on December 31, 1976, in the hands of the first decedent.

The bill would make it clear that only one fresh start basis adjustment may be made with respect to any carryover basis property. The adjustment is to be made with respect to the first death-time transfer of the eligible property after 1976.

**7. Holding Period for Carryover Basis Property (sec. 3(c)(4) of the bill and sec. 1223 of the Code)**

Prior to enactment of the 1976 Act, a capital asset acquired or passing from a decedent was considered to have been held by the estate or heirs for the period required for long-term capital gains treatment. A conforming change was not made to this provision when the carryover basis provision was enacted by the 1976 Act.

The bill provides that, notwithstanding a shorter actual combined holding period by the decedent, his estate, and the heir, a capital asset which is carryover basis property is to be considered to have been held by the estate or heir for the applicable period required for long-term capital gains treatment.

**8. Adjustment to Carryover Basis Property for State Estate Taxes (sec. 3(c)(5) of the bill and sec. 1023 of the Code)**

Under the carryover basis provisions as added by the 1976 Act, an adjustment to basis is permitted for Federal and State death taxes attributable to appreciation. With respect to State estate taxes, the adjustment is made to property subject to tax for Federal estate tax purposes. However, where the inclusion rules for State and Federal estate tax purposes are different, the present rule does not properly state how the basis adjustment for State estate taxes would be made.

The bill would modify the rule so that the basis adjustment for State estate taxes is to be made in reference to the estate tax inclusion rules under the applicable State law.

**9. Clarification of Increase in Basis for Certain State Succession Taxes (sec. 3(c)(6) of the bill and sec. 1023(e) of the Code)**

Under the carryover basis provisions as added by the 1976 Act, an adjustment to basis is permitted for State death taxes attributable to appreciation that are paid by the heir and for which the estate is not liable (sec. 1023(e)). This adjustment was intended to apply to State inheritance and succession taxes actually paid by an heir. However, under most State laws, the estate is technically liable for the payment of these taxes and, as a result, it is somewhat unclear as to whether an adjustment would be permitted in such cases. The bill makes it clear that the adjustment will be available for State death taxes actually paid by an heir or trust for the benefit of heirs.

**10. Coordination of Carryover Basis Adjustments (sec. 3(c)(7) of the bill and sec. 1023 of the Code)**

Under the carryover basis provisions as added by the 1976 Act, adjustments to basis are permitted for (1) the so-called "fresh-start" adjustment to reflect fair market value at December 31, 1976, (2) the Federal and State estate taxes attributable to appreciation, (3) a minimum basis of \$60,000, and (4) State inheritance taxes paid by the heir. Under the order prescribed for making these adjustments, the fresh start adjustment would be made first. The fresh start adjustment would then affect the amount of the other adjustments since it would be taken into account in measuring the amount of appreciation for purposes of the death tax adjustments and in determining whether the basis of all properties was less than the \$60,000 minimum basis. However, the fresh start adjustment is taken into account only for purposes of determining gain from the sale or other disposition of the property by the estate or heirs and cannot be used to generate a loss from the sale or other disposition of the property. Accordingly, it has been argued that recomputations of the death tax adjustments and the minimum basis adjustments for each item of property may be required every time any heir sells appreciated "fresh start" property.

The bill would make it clear that no recomputation of the basis is required for the death tax or minimum basis adjustments. Basically, the basis of "fresh start" property for loss purposes would be the same as for gain purposes except that it would not reflect the fresh start adjustment.

**11. Basis for Certain Term Interests (sec. 3(c)(8) of the bill and sec. 1001 of the Code)**

In determining the amount of gain or loss from the sale of a term interest (such as a life estate, term of years, or an income interest in a trust), the basis of property acquired or passing from a decedent or transferred by gift is not generally taken into account by the holder of the term interest. Rather, the basis is taken into account by the holder of the remainder interest. A conforming amendment was not made under the 1976 Act to apply this provision to carryover basis property.

The bill applies the basis rule for sales or other dispositions of term interests to carryover basis property.

**12. Clarification of the Rules Relating to Special Use Valuation  
(sec. 3(d)(1) of the bill and sec. 2032A of the Code)**

Under the 1976 Act, if certain conditions are met, “qualified real property” may be valued for estate tax purposes at its farm or business use value, rather than at its value based on “highest and best” use. To qualify for the special use valuation rule, several requirements must be satisfied. First, the real property must have been owned by the decedent (or a member of his family) and used for farm or business purposes for five of the eight years preceding the decedent’s death. Second, a substantial portion of the adjusted gross estate must consist of qualified property, i.e., 50 percent must consist of real and personal property used in the business and 25 percent must consist of real property used in the business. Third, qualified property referred to in the preceding sentence must pass to members of the decedent’s family (known as “qualified heirs”). Also, the decedent or a member of his family must have materially participated in the business in which the property is used for five of the eight years preceding the decedent’s death.

If these requirements are satisfied, it is unclear whether the remaining farm or business property of the decedent may be valued under the special use valuation rules even if it passes to persons who are not qualified heirs.

The bill makes it clear that real property is eligible for special use valuation only to the extent that it passes to qualified heirs.

**13. Use of Special Use Valuation Property to Satisfy Pecuniary Bequest (sec. 3(d)(2) of the bill and sec. 2032A of the Code)**

Under present law, the distribution of property by an estate or trust in satisfaction of a right to receive a specific dollar amount (that is, a pecuniary bequest) is treated as a taxable transaction resulting in the recognition of gain or loss to the estate. Since the distribution is treated as a taxable transaction, the property is not considered to have been acquired from or passed from a decedent. Thus, property otherwise qualifying for farm valuation would not appear to qualify if it were distributed pursuant to a pecuniary bequest.

The bill provides that, under the special use valuation provision, property shall be considered to have been acquired from or to have passed from a decedent if it is acquired by any person from the estate in satisfaction of the right of the person to a pecuniary bequest.

**14. Gain Recognized on Use of Special Use Valuation Property to Satisfy Pecuniary Bequest (sec. 3(d)(3) of the bill and sec. 1040 of the Code)**

Under present law, the distribution of property by an estate or trust in satisfaction of a right to receive a specific dollar amount (that is, a pecuniary bequest), is treated as a taxable transaction resulting in the recognition of gain or loss to the estate.

Under the law prior to the 1976 Act, the amount of gain or loss recognized on a distribution in satisfaction of a pecuniary bequest was limited to post-death appreciation because the estate received a stepped-up basis for the property. As a conforming change under the carryover basis provisions added by the 1976 Act, the Act also provided that, where an estate distributes property in satisfaction of a

pecuniary bequest, gain is recognized by the estate only to the extent of the appreciation occurring from the date of the decedent's death to the date of distribution.

The limitation on gain recognized by the estate was intended to provide substantially the same income tax treatment provided under prior law for a pecuniary bequest distribution. However, under the statute, the amount of post-death appreciation is considered to be the difference between the value of the property for estate tax purposes and its fair market value on the date of distribution. Thus, if the statute is literally applied where property is subject to special farm or other business use valuation, a portion of the pre-death appreciation will be included in the gain recognized by the estate because the gain would be the excess of the value at the time of distribution over the special use value used for estate tax purposes.

The bill makes it clear that where an estate or trust satisfies a pecuniary bequest with appreciated property which is subject to the special farm or other business use valuation for estate tax purposes, the gain recognized will include only appreciation occurring after the date of death.

**15. *Treatment of Community Property Under Special Use Valuation Provision (sec. 3(d)(4) of the bill and sec. 2032A of the Code)***

Under present law it is unclear whether the special use valuation provision for qualified real property applies in the same manner to property held as community property as it does to property held by the decedent as his individual property in a common law State.

The bill makes it clear that the special use valuation provision is to apply to community property in the same manner as property owned by the decedent in his individual capacity.

**16. *Bond to Relieve Qualified Heir of Personal Liability for Recapture of Tax Where Special Use Valuation is Utilized (sec. 3(d)(5) of the bill and sec. 2032A of the Code)***

Under the special use valuation provision added by the 1976 Act, the tax savings made possible from special farm or other business use valuation is recaptured (in whole or in part) if the property is transferred outside of the decedent's family, or is used for a nonqualified use, within 15 years after the decedent's death. Under this provision, the qualified heir is personally liable for the recapture tax imposed on his interest in the qualified real property and, in addition, a lien for the tax is imposed on the property.

The bill provides that the qualified heir may be discharged from personal liability if the heir furnishes a bond for the maximum amount of recapture tax which may be imposed with respect to his or her interest in the qualified real property.

**17. *Security Where Extended Payment Provisions are Elected (sec. 3(e) of the bill and sec. 6324A of the Code)***

Under present law as amended by the 1976 Act, there are two provisions permitting extended payment of estate taxes (over 15- or 10-year periods) where a farm or closely held business constitutes a substantial portion of the decedent's estate. Prior to the 1976 Act, where extended payment was elected, the executor was generally

personally liable for the deferred estate taxes unless he posted bond equal to double the amount of the unpaid tax.

The 1976 Act relieved the executor from personal liability for the unpaid tax where one of these extended payment provisions is elected. Instead, if elected, a lien attaches to real property and other assets with long useful lives until the deferred taxes are paid. The amount of the lien is equal to the deferred tax liability plus the total amount of interest which will be payable on the deferred taxes.

Generally, if the liability for the deferred taxes is accelerated, collection will ordinarily be made within a relatively short time. Thus, it has been argued that there would be adequate security for the deferred taxes without having a lien for the amount of interest which would be payable over the entire deferral period.

The bill provides that the amount of the lien is equal to the amount of the deferred taxes plus the aggregate amount of interest payable over the first 4 years of the deferral period.

***19. Transfer Within Three Years of Death (sec. 3(f) of the bill and sec. 2035 of the Code)***

Under the 1976 Act, transfers made by a decedent within three years of death are included in the decedent's gross estate without regard to whether gifts were actually made in contemplation of death. However, the 1976 Act provided an exception to the automatic three-year inclusion rule for gifts excludable under the \$3,000 annual gift tax exclusion. Under this exception, the legislative history indicated that the amount of gifts included in the gross estate is limited to the excess of the estate tax value over the amount excludable with respect to these gifts. It has been suggested that this rule will impose serious administrative burdens upon executors as it will be necessary to ascertain whether the decedent had made gifts during the 3-year period (even though no return was required), and, if so, the value of the gifts at the time of the donor's death.

The bill provides that the exception to the estate tax inclusion rule applies to gifts made to a donee where no gift tax return was required to be filed with respect to the gifts, e.g., gifts to a donee that do not exceed \$3,000 in a calendar year. If the gifts are required to be shown on a gift tax return, the gifts made within three years of the decedent's death are required to be included in the decedent's gross estate. This exception does not apply with respect to the gift of a life insurance policy.

***20. Co-ordination of Gift Tax Exclusion and Estate Tax Marital Deduction (sec. 3(g)(1) of the bill and sec. 2056 of the Code)***

Under the 1976 Act, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first \$100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal gifts in excess of \$200,000.

In addition, where interspousal gifts are less than \$200,000, the allowable estate tax marital deduction is reduced (or "cut-down") by the excess of the gift tax marital deduction with respect to gifts made after 1976 over 50 percent of the value of all such gifts to this spouse made after 1976. However, no adjustment in the allowable estate tax marital deduction is made where an inter-spousal lifetime

gift is included in the estate of the donor spouse because it was made within 3 years of death.

Where property which was given to the decedent's spouse is included in the decedent's estate as a transfer made within 3 years of death, the estate tax marital deduction should not be reduced on account of the gift tax marital deduction since inclusion of the gift in the gross estate will have nullified any benefit of the deduction for gift tax purposes. The bill solves the problem by providing that the estate tax marital deduction for gifts to the decedent's spouse will not be reduced on account of gifts made to the surviving spouse within 3 years of death.

**21. Co-ordination of Gift Tax Exclusion and Estate Tax Marital Deduction (sec. 3(g)(2) of the bill and sec. 2056 of the Code)**

Under the 1976 Act, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first \$100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal gifts in excess of \$200,000.

In addition, where interspousal gifts are less than \$200,000, the allowable estate tax marital deduction is reduced (or "cut-down") by the excess of the gift tax marital deduction with respect to gifts made after 1976 over 50 percent of the value of all gifts to the spouse made after 1976. Thus, where the unlimited \$100,000 gift tax marital deduction has been used up but the aggregate gifts to a spouse do not exceed \$200,000, the present formula will reduce the estate tax marital deduction "cut-down" for subsequent gifts of \$3,000 or less to a spouse during a year even though those gifts are excluded from tax and no gift tax return is required for those gifts.

Because no gift tax return is required to be filed where the total gifts to a donee (other than gifts of a future interest) do not exceed \$3,000 per year, it is difficult for the executor to determine the amount of these small gifts for purposes of computing the allowable estate tax marital deduction. The bill solves this problem by excluding any gift not required to be in a gift tax return from the computation of the estate tax marital deduction "cut-down."

**22. Split Gifts Made Within Three Years of Death (sec. 3(h) of the bill and sec. 2001 of the Code)**

Under the gift tax law, a spouse may consent to be treated as the donor of one-half of a gift made by the other spouse to a third party. This is referred to as "gift splitting." Under the 1976 Act, where the donor spouse dies within 3 years of making a "split gift," the entire gift is included in the donor spouse's estate and any gift tax actually paid by the consenting spouse on the gift is allowed as a credit in determining the estate tax for the estate of the donor spouse. However, the transfer tax consequences to the consenting spouse are not reversed. For example, any unified credit used is not restored and the amount of aggregate taxable gifts for prior periods is not adjusted.

The bill would generally provide for the reversal of the transfer tax consequences of gift splitting to the estate of the consenting spouse if the gift is included in the gross estate of the donor spouse as a transfer made within three years of death.

**23. Inclusion in Gross Estate of Stock Transferred by the Decedent Where the Decedent Retained Voting Rights (sec. 3(i) of the bill and sec. 2036(b) of the Code)**

Under present law, the retention of certain powers or interests by a decedent in property transferred by the decedent during his lifetime results in the property being includible in his gross estate for estate tax purposes (sec. 2036). The 1976 Act extended this rule to the retention of voting rights in stock of any corporation which was transferred by the decedent during his lifetime even if the corporation was not a controlled corporation. This rule is often called the "anti-*Byrum*" rule because it was intended to overrule the result reached in that case by the U.S. Supreme Court.

It has been argued that it is inappropriate to apply the voting retention rule to stock in corporations which are not controlled by the decedent and his relatives. In addition, it has been suggested that the 1976 Act rule did not apply to certain indirect retentions of voting rights.

The bill amends the voting retention rule so that it applies only where the corporation is controlled (i.e., the decedent and his relatives own 20 percent of the corporation). In addition, the bill makes it clear that the rule applies to the indirect retention of voting rights in stock of a controlled corporation where the decedent subsequently acquires voting rights in stock of the corporation.

**24. Estate Tax Exclusion for Certain Retirement Benefits (sec. 3(j)(1) of the bill and sec. 2039(d) of the Code)**

Under present law as added by the 1976 Act, annuities paid from individual retirement accounts, individual retirement annuities, and individual retirement bonds are excluded from the decedent's gross estate. The Act is somewhat unclear whether this exclusion applies in the case where contributions were deductible under a spouse-covered individual retirement account (sec. 220).

The bill makes it clear that annuities paid from a spouse-covered individual retirement account qualify for the estate tax exclusion.

**25. Annual Exclusion for Spouse's Interest in an Individual Retirement Account (sec. 3(j)(2) of the bill and sec. 2503 of the Code)**

The 1976 Act added provisions under which special income tax treatment was provided with respect to an individual retirement account, annuity, or bond for the benefit of an individual and his spouse. However, it is unclear as to whether a contribution to the account for the benefit of the spouse would be considered a gift eligible for the gift tax \$3,000 annual exclusion since an interest must be a present interest in property to be eligible for the exclusion.

The bill would make it clear that the contributions made for the benefit of a spouse under an individual retirement account are not considered to be gifts of a future interest and therefore are to be eligible for the annual exclusion.

**26. Gift Tax Consequences From the Creation of a Joint Tenancy In Personal Property (sec. 3(k)(1) of the bill and sec. 2515A of the Code)**

Under present law, the creation of a joint tenancy in personal property with rights of survivorship constitutes a gift to the extent

that the contribution made by a tenant exceeds the tenant's retained interest in the property. A similar rule applies in the case of a joint tenancy created in real property without rights of survivorship between spouses. In the case of a joint tenancy in real estate with rights of survivorship between spouses, no gift tax is imposed unless the donor spouse elects to treat the creation as a gift. Prior to the 1976 Act, when an election was made, the amount of the donor spouse's retained interest in realty was determined by use of actuarial factors if, under applicable local law, neither joint tenant could unilaterally sever the joint tenancy.

The 1976 Act eliminated the need to use actuarial calculations in the case of the creation of a joint tenancy by the husband and wife in real property. Under the Act, the retained interest of each spouse is considered to be one-half the value of the property even if neither joint tenant can not unilaterally sever the joint tenancy. However, the rule eliminating the use of actuarial values did not apply to the creation of a joint tenancy between husband and wife in personal property.

The bill generally eliminates actuarial calculations in determining the amount of a gift with respect to the creation of a joint tenancy between husband and wife in personal property. However, actuarial calculations will continue to be required if the fair market value of the joint interest of the personal property cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses. Thus, for example, the amount of a gift would continue to be determined actuarially in the case of a gift involving a joint and survivor annuity.

**27. Fractional Interest Rule for Certain Joint Tenancies (sec. 3 (k)(2) of the bill and sec. 2040 of the Code)**

Prior to the 1976 Act, the estate tax law provided that on the death of a joint tenant, the entire value of the property owned in joint tenancy was included in a decedent's gross estate except for the portion of the property which is attributable to the consideration furnished by the survivor.

The 1976 Act added a provision which provided that in the case of a "qualified joint interest" created after December 31, 1976, one-half of the value of a joint interest would be included in an estate of the first tenant to die. A qualified joint interest is a joint tenancy between a decedent and his spouse created by one or both spouses, the creation of which in the case of personal property constituted a gift in whole or in part, or in the case of real property an election was made to treat the creation as a transfer of property. Although the 1976 Act made no change with respect to joint interests created before January 1, 1977, a taxpayer can get the benefit of the new fractional interest rule by severing an existing joint tenancy and re-creating it if the re-creation is subject to a gift tax.

The bill allows a donor spouse to have a pre-1977 joint tenancy to be treated as a "qualified joint interest" without formally severing the joint tenancy and then re-creating it. This treatment is to be available if the taxpayer elects to report a gift of the property in a gift tax return filed with respect to any calendar quarter in 1977, 1978 or 1979. A taxpayer making the election is to be treated as having made a gift at the close of calendar quarter for which the return is filed. The



amount of the gift generally is to be equal to one-half of the appreciation attributable to the consideration furnished by the donor spouse at the time of the creation of the joint interest.

**28. Amendments Relating to Orphan's Exclusion (sec. 3(l) of the bill)**

**a. Orphan's Exclusion Where There is a Trust for Minor Children (sec. 3(l)(1) of the bill and sec. 2057(d) of the Code)**

The 1976 Act provided a limited deduction for estate tax purposes for amounts passing from the decedent to his orphaned children. In order to qualify for the deduction, the property passing to the orphaned child may not be a terminable interest (such as a life estate), except that the property is permitted to pass to a person other than the child's estate if the child dies before attaining age 21. Because of this rule, it is not possible under the 1976 Act to create a single trust for the benefit of a number of orphaned children as a group.

The bill provides that property passing to a "qualified minors' trust" will qualify for the orphan's exclusion. Basically, a qualified minors' trust is one which, initially, is entirely for the benefit of the decedent's minor orphaned children. Distributions to these orphaned children must be made on a pro rata basis or made under one or more ascertainable standards relating to the health, education, support, or maintenance of the orphaned children. At the death of an orphaned child, his share of the trust must either (1) remain in the trust for the benefit of other orphaned children, or (2) it must vest (as a distribution or separate share) in another person. When the youngest orphaned child attains age 23, all interests in the trust must be vested on a pro rata basis in the orphaned children living at that time.

**b. Increasing to Age 23 for Terminable Interest in the Care of Orphans' Exclusion (sec. 3(l)(2) of the bill and sec. 2057(c) of the Code)**

The 1976 Act provided a limited deduction for estate tax purposes for amounts passing from the decedent to his orphaned children. In order to qualify for the deduction, the property passing to the orphaned child may not be a terminable interest (such as a life estate), except that the property is permitted to pass to a person other than the child's estate if the child dies before attaining age 21.

The bill increases the age by which the property may pass to another in the case of the orphaned child's death from age 21 to age 23.

**29. Disclaimers (sec. 3(m) of the bill and sec. 2518 of the Code)**

Under the 1976 Act, in order for a disclaimer to be valid for purposes of estate, gift and generation-skipping transfer taxes so that the person disclaiming is not treated as having transferred the property, the disclaimed interest must pass to a person other than the person making the disclaimer. To satisfy this requirement, the person making the disclaimer cannot have the authority to direct the transfer of the property to another person. It is presently unclear as to whether a disclaimer is valid for tax purposes where a surviving spouse refuses to accept all or a portion of an interest in property passing from the decedent and, as a result of that refusal, the property passes to a trust in which the spouse has an income interest.

The bill provides that, where a surviving spouse refuses to accept an interest in property, the disclaimer will be valid although the surviving spouse receives an income interest with respect to the property if the income interest does not result from any direction by the surviving spouse and the disclaimer is otherwise qualified.

**30. Termination of Certain Powers of Independent Trustees Not Subject to Tax on Generation-Skipping Transfers (sec. 3(n)(1) of the bill and sec. 2613 of the Code)**

Under the 1976 Act, a transfer tax was imposed on taxable distributions or taxable terminations of powers and interests in a generation-skipping trust. The term "power" means any power to alter or establish the beneficial enjoyment of the corpus or income of the trust. However, there is an exception to this rule where the only power held is one to allocate the corpus or income to lineal descendants of the grantor of the trust who are members of generations younger than that of the individual holding the power.

This provision creates problems in cases where the grantor wishes to employ an independent individual trustee (that is, a non-family member who is not subject to family control). The same problems do not arise where a corporate trustee is used because the termination of a corporate interest does not trigger generation-skipping tax unless there is reason to look through the corporation to individual beneficiaries.

The bill provides that an individual independent trustee will not be treated as having a power in the trust if his only power or interest is the power to dispose of the trust corpus or income for a beneficiary or class of beneficiaries designated in the trust instrument. For purposes of these rules, an independent trustee is a person who (1) is not closely related to the grantor of the trust or any beneficiary, or (2) is not an employee of a corporation where the grantor or beneficiaries are executives or have significant voting power.

**31. Clarification of Rules Where a Beneficiary Has More Than One Power or Interest in a Generation-Skipping Trust (sec. 3(n)(2) of the bill and sec. 2613 of the Code)**

Under the 1976 Act, where a beneficiary has more than one interest or power in a generation-skipping trust, the generation-skipping tax is generally postponed until the termination of the last such interest or power. The bill clarifies that postponement of the tax will occur only where the several interests or powers held by the beneficiary are present interests or powers. Thus, where only one of the interests or powers is a present interest or power (and the other interest or power is merely a future interest or power), the tax will not be postponed on the termination of the present interest or power.

**32. Alternate Valuation Date in the Case of a Generation-Skipping Trust (sec. 3(n)(3) of the bill and sec. 2602 of the Code)**

Under present law, the alternate valuation date is to be available for generation-skipping trusts where the taxable termination occurs by reason of death. However, it appears that the alternate valuation treatment is not made available in certain limited circumstances where the generation-skipping tax is postponed because the trust

property passes to an older generation beneficiary for life before passing to younger generation beneficiaries.

The bill corrects this technical oversight and permits use of the alternate valuation date in those cases.

**33. *Adjustment for Trust Accumulation Distribution Subject to Transfer Tax (sec. 3(o) of the bill and sec. 667 of the Code)***

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for Federal estate taxes attributable to appreciation. This adjustment is designed to prevent the imposition of an income tax on the portion of the estate taxes attributable to appreciation. Similarly, when property has been sold before death but the gain is recognized by the heirs for income tax purposes, the death taxes attributable to the gain are allowable as a separate deduction in computing the taxable income of the heirs (rather than as an adjustment to the basis of the property sold). In addition, similar adjustments are also permitted with respect to generation-skipping taxes imposed under the 1976 Act. However, the 1976 Act did not provide for an adjustment having a similar effect for trust distributions of accumulated income with respect to which an estate tax or generation-skipping tax had been imposed.

The bill provides that the tax imposed on a beneficiary with respect to an accumulation distribution will take into account the estate tax or generation-skipping tax attributable to the accumulated income.

**34. *Clerical Amendments (sec. 3(p) of the bill and secs. 1016, 2051, 6324B and 6698 of the Code)***

*Amendment of sec. 6698.* The 1976 Act added two new section 6694's. The section 6694 relating to failure to file information with respect to carryover basis property is redesignated as section 6698.

*Amendment of sec. 2051.* This provision deletes a reference to the estate tax exemption which was repealed by the 1976 Act.

*Amendment of sec. 1016.* The paragraph added by the 1976 Act as paragraph (23) of section 1016(a) is redesignated as paragraph (21).

*Amendment of sec. 6324B.* This provision corrects a reference in section 6324B to conform the term "qualified real property" to its definition in section 2032A.

**C. OTHER CLERICAL CORRECTIONS, CROSS  
REFERENCES, ETC.**

**1. Cross References Relating to the Investment Credit (sec. 4(a) of the bill and secs. 46 and 48 of the Code)**

a. *Amendment of section 46(f)(8).*—The first sentence of section 46(f)(8) is amended to change the cross reference to subsection (a)(7)(D) of section 38 instead of subsection (a)(6)(D).

b. *Amendment of section 46(g)(5).*—The cross reference in section 46(g)(5) is corrected to the Merchant Marine Act, 1936 instead of the Merchant Marine Act, 1970.

c. *Amendment of section 48(d)(1)(B).*—The cross reference in section 48(d)(1)(B) is corrected to be section 46(a)(6) instead of section 46(a)(5).

d. *Amendment of section 48(d)(4)(D).*—The cross reference in section 48(d)(4)(D) is corrected to be section 57(c) instead of section 57(c)(2).

**2. Prepaid Legal Services (sec. 4(b) of the bill, section 2134(e) of the Tax Reform Act of 1976, and sec. 501(c)(20) of the Code)**

a. The reference in section 2134(e) of the Tax Reform Act of 1976 is corrected to be section 120(d)(7) of the Code instead of section 120(d)(6).

b. A clerical change is made in section 501(c)(20) of the Code to delete the internal reference to “section 501(c)(20)” and instead refer simply to “this paragraph.”

**3. Corrections Relating to Individual Retirement Account Provisions (sec. 4(c) of the bill and secs. 219(c)(4), 220(b)(1)(A), 220(b)(4), and 408(d)(4) of the Code)**

a. *Amendment of section 219(c)(4).*—The reference in section 219(c)(4) is corrected to be subsection (b)(2)(A)(iv) instead of subsection (b)(3)(A)(iv).

b. *Amendment of section 220(b)(1)(A).*—This corrects a clerical error in section 220(b)(1)(A) of the Code.

c. *Amendment of section 220(b)(4).*—This clarifies the reference to “any payment” by indicating that it refers to “any payment described in subsection (a)” of section 220 of the Code.

d. *Amendment of section 408(d)(4).*—A clerical correction is made to section 1501(b)(5) of the Tax Reform Act of 1976 so that each reference in Code section 408(d)(4) to section 219 is also followed by “or 220” as was intended in the drafting of the Act.

**4. Accrual Accounting for Farm Corporations (sec. 4(d) of the bill and sec. 447(a) and (g)(2) of the Code)**

A correction is made to sections 447(a) and (g)(2) of the Code to refer to “preproductive period expenses” instead of to “preproductive expenses” in order to conform these references to the exact term as defined in section 447(b)(1).

**5. Renumbering of Section 911(c) (sec. 4(e) of the bill and sec. 911(c) of the Code)**

A clerical change is made by renumbering section 911(c)(8) as section 911(c)(7).

**6. Transition Rule for Private Foundations (sec. 4(f) of the bill and sec. 101(l)(2)(F) of the Tax Reform Act of 1969)**

A modification of the 1969 Act's transitional rule for sales of property by private foundations was made by section 1301(a)(3) of the Tax Reform Act of 1976. This provision of the bill corrects a clerical error made in that modification by inserting a comma in lieu of the period at the end of clause (i) of section 101(l)(2)(F) of the 1969 Act, as amended by the 1976 Act.

**7. Lobbying by Public Charities (sec. 4(g) of the bill and secs. 501, 4911, 6213, and 6405 of the Code)**

The bill makes a clerical change in the heading of the table setting forth the lobbying nontaxable amounts of public charities to reflect that the proper base for measuring such amounts is "exempt purpose expenditures". The bill also makes technical amendments to section 501 of the Code (relating to exempt organizations) to correct clerical errors in the coordination of subsection designations by the Tax Reform Act of 1976 and Public Law 94-568. The bill also amends the Code provisions to provide that the same rules relating to the treatment of mathematical errors, and the rules relating to reports of large refunds to the Joint Committee on Taxation, apply to the excise tax on excess expenditures to influence legislation and the tax on undistributed REIT income as apply to private foundation excise taxes and excise taxes on qualified pension, etc. plans.

**8. Amendments to Foreign Tax Provisions (sec. 4(h) of the bill and sec. 1035 of the Tax Reform Act of 1976 and sec. 999 of the Code)**

a. A clerical change is made to section 1035(c)(2) of the Tax Reform Act of 1976 to make it clear that the phrase "oil and gas extraction income" has the same meaning for purposes of that section as its meaning in section 907(c) of the Code.

b. The cross reference in section 999(c)(1) of the Code is corrected to be 995(b)(1)(F)(ii) rather than section 995(b)(3).

c. The cross reference in section 999(c)(2) of the Code is corrected to be section 995(b)(1)(F)(ii) instead of section 999(b)(1)(D)(ii).

**9. Amendments to DISC provisions (sec. 4(i) of the bill and secs. 995 and 996 of the Code and sec. 1101 of the Tax Reform Act of 1976)**

a. The reference in section 995(b)(1) of the Code to "gross income (taxable income in the case of subparagraph (D))" is changed to refer simply to income. In addition, the reference to subparagraph (E) is corrected to be a reference to subparagraph (G).

b. The cross reference in section 996(a)(2) of the Code is corrected to be section 995(b)(1)(G) instead of section 995(b)(1)(E).

c. The cross reference in section 1101(g)(5) of the Tax Reform Act is corrected to be section 995(e)(3) instead of section 993(e)(3).

**10. Clerical Amendments Relating to “Deadwood” Provisions (sec. 4(j) of the bill)**

**a. Tax-Exempt Governmental Obligations (sec. 4(j)(1) of the bill and sec. 103 of the Code)**

This paragraph provides a number of amendments to section 103 of the Code to conform to amendments made to section 103 by sections 1901(a)(17) and 2105 of the Tax Reform Act of 1976.

**b. Cross Reference (sec. 4(j)(2) of the bill and secs. 6504 and 6515 of the Code)**

This provision corrects a typographical error made in section 1901(b)(37)(D) of the Tax Reform Act of 1976.

**c. Effective Dates of Tax Reform Estate and Gift Tax Amendments (sec. 4(j)(3) of the bill and sec. 1902(c) of the Tax Reform Act of 1976)**

This provision corrects a group of clerical errors in section 1902(c) (providing effective dates for the “Deadwood” estate and gift tax amendments) of the Tax Reform Act of 1976. These errors resulted because the effective date provisions for the estate and gift tax amendments of the Code made by Title XIX of the Tax Reform Act (the so-called Deadwood amendments) were not conformed to amendments to the same estate and gift tax sections of the Code made by other titles of the Act.

**d. Tax on Excess Retirement Plan Contributions (sec. 4(j)(4) of the bill and sec. 4973(a) of the Code)**

This deletion is necessary because the Tax Reform Act erroneously gave section 1904(a)(22)(A) of the Act, which provided a technical amendment to section 4973(a) of the Code, an effective date that was subsequent to the effective date of section 1501(b)(8) of the Act, which made a substantive change to that same section of the Code. As a result, except for this provision of the bill, the technical correction language of section 1904(a)(22)(A) of the Act would replace the more complete amendment made to section 4973(a) of the Code by section 1501(b)(8) of the Act. This provision of the bill advances the effective date of the language of section 1904(a)(22)(A) of the Act thereby leaving in place the amendment made by section 1501 (b)(8) of the Act.

**e. Definitions Relating to the Tax on Self-Employment Income (sec. 4(j)(5) of the bill and sec. 1402 of the Code)**

This provision makes two clerical amendments to section 1402 of the Code to conform to the amendment made to section 1402 by section 1901(a)(155)(B) of the Tax Reform Act of 1976.

**f. Social Security Act Amendments (sec. 4(j)(6) of the bill and secs. 202, 205, 210, and 211 of the Social Security Act)**

This provision makes a number of amendments to sections of the Social Security Act to conform to several amendments made to the Internal Revenue Code by the Tax Reform Act of 1976.

***g. Special Tax Rules Affecting Territories (sec. 4(j)(7) of the bill and sec. 37 of the Code)***

This provision repeals section 1901(c)(1) of the Tax Reform Act of 1976. That provision of the Tax Reform Act, which amended section 37(f) of the Code by eliminating an obsolete reference to a "Territory," was made superfluous by a substantive amendment made to that same section of the Code by section 503(a) of the Tax Reform Act.

***h. Computing the Amount of the Investment Credit (sec. 4(j)(8) of the bill and sec. 46 of the Code)***

This provision amends section 1901(b)(1)(C) of the Tax Reform Act of 1976 to conform to an amendment made by section 802(a)(1) of that Act. Section 1901(b)(1)(C) of the Act made an amendment to section 46(a)(3) of the Code, but that amendment should have been made to section 46(a)(4) of the Code inasmuch as section 46(a)(3) was redesignated as section 46(a)(4) by section 802(a)(1) of the Act. This provision of the bill amends section 1901(b)(1)(C) of the Act to make it refer, as it should, to section 46(a)(4) of the Code.

***i. Installment Method of Accounting (sec. 4(j)(9) of the bill and sec. 453 of the Code)***

This provision eliminates the effects of a deadwood change made to section 453 of the Code by section 1901(a)(66)(A) of the Tax Reform Act of 1976. The language in section 453 of the Code which was amended by the Tax Reform Act is considered obsolete and therefore can be deleted in its entirety.

***j. Definition of Life Insurance Company (sec. 4(j)(10) of the bill and sec. 801 of the Code)***

This amendment makes conforming changes to reflect the amendment of section 805 of the Code (relating to pension plan reserves) made by section 1901(a)(97)(C) of the 1976 Act. The Act deleted from section 805 an obsolete transitional rule and renumbered the remaining provisions, but failed to make a conforming change in section 801(g) of the Code (relating to contracts with reserves based on segregated asset accounts). Accordingly, the bill deletes from section 801(g)(1)(B)(ii) and (7) the references to "subparagraph (A), (B), (C), (D), or (E) of section 805(d)(1)" and substitutes simply a reference to section 805(d).

***11. Capital Loss Carryovers (sec. 4(k) of the bill and sec. 1212 of the Code)***

This provision corrects the phrase "exceeding the loss year" to read "succeeding the loss year."

***12. Aircraft Museums (sec. 4(l) of the bill and secs. 4041, 6427, and 7609 of the Code)***

This amendment makes several clerical and conforming changes arising under P.L. 94-530, which provides an exemption from the fuel and aircraft use excise taxes for certain aircraft museums. A clerical change is made to insert an omitted word in section 4041(h)(2), added by P.L. 94-530. In addition, conforming changes are made to correct cross references in section 4041 and other Code provisions, and to conform the aircraft museum amendments with changes made by the deadwood provisions of the Tax Reform Act of 1976.

***13. Inspection by Congress (sec. 4(m) of the bill and sec. 6104 of the Code)***

This provision corrects a cross reference in section 6104 to section 6103.

***14. Limitation on Assessment and Collection (sec. 4(n) of the bill and sec. 6501 of the Code)***

This provision corrects a reference in section 6501 to section 6213 (b)(3).



### **III. Revenue Effect**

It is estimated that the provisions contained in the bill, H.R. 6715, will not have any overall revenue impact. It should be noted that certain individual provisions may appear to result in a minor revenue increase or decrease. However, the revenue effects which were included in the Tax Reform Act of 1976 took into account the basic Congressional policy contained in the revisions made by this bill.

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