[JOINT COMMITTEE PRINT]

# DESCRIPTION OF TAX BILLS

## (S. 31, S. 239 AND S. 452)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON FEBRUARY 23, 1981

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PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

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## INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on February 23, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are three bills scheduled for the hearing: S. 31 (relating to deductions for business use of homes and rental of residences to family members), S. 239 (relating to tax incentives for purchase of commuter highway vehicles), and S. 452 (relating to treatment of gain on sale or exchange of foreign investment company stock).

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

## I. SUMMARY

### 1. S. 31—Senators Armstrong, Dole, Boren, Mathias, Goldwater, and Exon

#### Deductions for Business Use of Homes and Rental of Residences to Family Members

This bill would amend section 280A to provide explicitly that a taxpayer may have a principal place of business within his home for any separate trade or business, and to remove certain present law limitations on the deductibility of expenses incurred in the rental of residences to family members. The bill also would prevent any ruling or regulation from treating a day on which the taxpayer is engaged on a substantially full-time basis in repair or maintenance work on a rental dwelling unit as a day of personal use because other individuals may not be similarly engaged in full-time work on that day. The provisions of the bill would apply to all taxable years to which section 280A applies.

### 2. S. 239—Senators Durenberger, Percy, Bentsen, Hayakawa, Pell, Tsongas, Hatfield, Heflin, Mathias, Specter, Sasser and Ford

#### Credit for Purchase of Commuter Highway Vehicles, Exclusions from Income of Alternative Commuter Transportation, and Credit for Ride-Sharing Expenses

Under present law, an employer is entitled to the regular 10-percent investment credit (but not an energy investment credit) on the purchase of a new commuter highway vehicle (sec. 46(c)(6)). When an employer uses leased vehicles to provide rides, the investment credit is allowed to the owner of the vehicles, under the general investment credit rules. The investment credit for a commuter highway vehicle is not allowed to a nonbusiness individual. The gross income of an employee does not include the value of employer-provided transportation in a commuter highway vehicle (sec. 124), although in general, amounts received by employees as reimbursement for otherwise nondeductible personal expenses must be included in gross income. To the extent that Federal, State or local taxes are imposed on motor fuels used in a taxpayer's trade, business or investment activity, they generally are deductible as ordinary and necessary business expenses or as expenses incurred in a profit seeking activity (secs. 162 and 212). However, such taxes are not deductible by an individual for the nonbusiness use of motor fuels.

Under the bill, a 15-percent income tax credit would be allowed to a nonbusiness individual for the purchase of a new commuter highway vehicle. The bill would exclude from an individual's gross income amounts received from the employer for trips between home

and work which are made on public transportation, employer-provided services performed in connection with a ride-sharing program and compensation received for transporting other individuals between home and work. The bill also would allow a 10-percent energy investment credit to businesses for the purchase of a new commuter highway vehicle and allow investment tax credits without regard to whether the riders are the taxpayer's employees. In addition, the bill would allow a new income tax credit to an employer who operates a qualified ride-sharing program which assists employees in obtaining certain transportation between their homes and work. Further, the bill would allow an itemized deduction for Federal, State or local taxes imposed on sales of motor fuels used in a ride-sharing vehicle.

### 3. S. 452—Senator Boren

### Gain on Sale of Stock of Foreign Investment Company

Under present law, gain from the sale of stock of a corporation which is, or at any time has been, a foreign investment company generally is treated as ordinary income to the extent of the selling shareholder's portion of the corporation's earnings and profits. Under the bill, gain attributable to earnings and profits for the period before the corporation became a foreign investment company would no longer be subject to this ordinary income treatment.

## II. DESCRIPTION OF BILLS

### 1. S. 31—Senators Armstrong, Dole, Boren, Mathias, Goldwater, and Exon

### Deductions for Business Use of Homes and Rental of Residences to Family Members

#### *Present law*

*General*

Section 280A, enacted as part of the Tax Reform Act of 1976, disallows the deduction of certain expenses incurred in connection with the use of the taxpayer's home in a trade or business or income producing activity or in connection with the rental of vacation homes and other residential real estate. The restrictions in section 280A were enacted to replace vague standards on which courts and the Internal Revenue Service differed with more definitive, objective statutory tests for determining the deductibility of expenses. Section 280A applies to individuals, trusts, estates, partnerships and electing small business corporations.

The deductions under sections 163, 164 and 165 for interest, certain taxes, and casualty losses attributable to a taxpayer's personal residence are not affected by section 280A.

*Business use of the home*

Unless specifically excepted from section 280A and otherwise allowable, no deductions are allowed with respect to a dwelling unit because of its connection to a taxpayer's trade or business or income producing activities, if the taxpayer uses the dwelling as a residence. One exception to the general rule of section 280A allows deductions attributable to a portion of the taxpayer's residence which is exclusively used on a regular basis as the taxpayer's principal place of business.

On August 7, 1980, proposed Treasury Regulations under section 280A were published in the Federal Register (45 Fed. Reg. 52399). The proposed regulations would define "the taxpayer's principal place of business" as the principal place of the taxpayer's overall business activity. A taxpayer would have only one principal place of business regardless of the number of business activities in which the taxpayer is engaged. The proposed regulations do not follow the U.S. Tax Court decision in *Curphey* v. *Commissioner*, 73 T.C. 766 (1980), which allowed a hospital-employed dermatologist to deduct expenses for a home office which was the principal place of business for his real estate rental business.

*Personal use of residence*

Section 280A, in general, limits the amount a taxpayer may deduct for expenses attributable to the rental of a dwelling unit, in many cases a vacation home, if the taxpayer uses the unit for personal purposes in excess of a specified period of time during a taxable year. This limi-

tation applies only if the taxpayer's use of the dwelling unit for personal purposes during a taxable year exceeds the greater of fourteen days or ten percent of the number of the days during the year for which the unit is rented. If a taxpayer exceeds these personal use limitations, deductions attributable to the rental activity are limited to the amount by which the gross income derived from the rental activity exceeds the deductions otherwise allowable without regard to such rental activities (*e.g.*, interest and certain taxes).

*Family rentals.*—The taxpayer generally is deemed to have used a dwelling unit for personal purposes for a day if, for any part of the day, the unit is used for personal purposes by (1) the taxpayer or any other person who owns an interest in the home; (2) the brothers and sisters, spouse, ancestors, or lineal descendants of the taxpayer or other owners; (3) any individual who uses the unit under a reciprocal arrangement (whether or not a rental is charged); or (4) any other individual who uses the dwelling unit during a day unless a fair rental is charged.

The Revenue Act of 1978 amended section 280A to provide that the use of a dwelling unit as a taxpayer's principal residence (within the meaning of section 1034) is not to be treated as personal use in determining whether the limitations of section 280A apply to deductions attributable to a "qualified rental period" which immediately precedes or follows a period of use as the taxpayer's principal residence. Under section 280A, a qualified rental period generally is a period of 12 or more consecutive months during which the unit is rented to a person other than a family member, or held for rental, at a fair rental.

*Repairs and maintenance.*—Section 280A also provides that the Secretary of the Treasury must prescribe the regulation the circumstances under which use of a dwelling unit for repairs and annual maintenance will not constitute personal use of the unit. Under the proposed regulations published on August 7, 1980, an individual would have to be engaged in repair or maintenance work for a day on a substantially full-time basis, *i.e.*, the lesser of eight hours or two-thirds of the time present on the premises, to qualify the day's use of the unit as use for repairs and maintenance. The proposed regulations would require that all individuals on the premises on a day must be engaged in work on the unit on a substantially full-time basis, to avoid the day being treated as one of personal use. However, the proposed regulations would disregard the presence of individuals, such as small children, who are incapable of working.

### *Issues*

The principal issues are, (1) whether business expenses attributable to the use of a portion of a taxpayer's residence as the principal place of business for a separate, secondary business of the taxpayer should be subject to the general rule of section 280A disallowing deductions for such expenses, (2) whether rental of a taxpayer's principal residence or another dwelling to a family member at a fair rental price should be treated in the same manner as a rental to an unrelated party, and (3) whether regulations should treat a taxpayer as having used a dwelling for personal purposes if the taxpayer spends a normal working day repairing or maintaining the dwelling while other persons, who are capable of working, use the dwelling for personal purposes.

### *Explanation of the bill*

The bill contains three amendments to section 280A and a provision relating to rulings and regulations of the Internal Revenue Service concerning use of a dwelling for maintenance and repair.

*Business use of the home*

The bill would amend section 280A(c)(1)(A) to provide that the general limitation on deductions in section 280A(a) shall not apply to expenses allocable to the regular and exclusive use of a portion of a taxpayer's residence as a principal place of business for any trade or business of the taxpayer. Thus, a taxpayer could have a distinct principal place of business for each separate trade or business and could deduct expenses attributable to the use of a residence as the principal place of business for one or more such businesses, provided the regular and exclusive use requirements are met.

*Family use of residence*

Two amendments would treat fair-market rentals to family members in the same way as rentals to unrelated parties, thus allowing deductions for expenses attributable to such rentals. Section 280A(d)(2) would be amended so that the use of a dwelling by a member of the family of either the taxpayer or any other person with an interest in the dwelling would not be considered the personal use of the dwelling by the taxpayer if the dwelling is rented to the family member at a fair rental.

Under section 280A(d)(3), a taxpayer's use of a dwelling as a principal residence is not considered personal use for any period immediately before or after a "qualified rental period." The bill would provide that a "qualified rental period" is a period of 12 or more months (or less than 12 months if the dwelling is sold or exchanged at the end of the period) for which a taxpayer's principal residence is rented or is held or rental at a fair rental, regardless of whether the dwelling is rented to a member of the taxpayer's family.

*Repair and maintenance*

The bill also would provide that, notwithstanding any ruling, proposed regulation, or regulation to the contrary, a dwelling would not be treated as used for the personal purposes of the taxpayer on a day the taxpayer repairs or maintains the dwelling on a substantially full-time basis because other persons, who are on the premises and who are capable of working, do not work on a substantially full-time basis.

### *Effective date*

The provisions of the bill would apply to taxable years beginning after December 31, 1975, the taxable years to which section 280A applies.

### *Revenue effect*

It is estimated that this bill would reduce budget receipts by $61 million in fiscal year 1981, by $77 million in fiscal year 1982, by $54 million in fiscal year 1983, by $61 million in fiscal year 1984, and by $69 million in fiscal year 1985.

## 2. S. 239—Senators Durenberger, Percy, Bentsen, Hayakawa, Pell, Tsongas, Hatfield, Heflin, Andrews, Mathias, Specter, Sasser and Ford

### Credit for Purchase of Commuter Highway Vehicles Exclusion from Income of Alternative Commuter Transportation, Credit for Ride-Sharing Expenses

#### *Present law*

*Credit for purchase of commuter highway vehicles*

Under present law, an employer is entitled to the regular 10-percent investment credit (but not an energy investment credit) on the purchase of a new "commuter highway vehicle" (sec. 46(c)(6). This is a special rule in that the regular investment credit for qualifying property generally is less than 10 percent for an asset with a useful life of less than 7 years. (Under the general rules, the credit is 3⅓ percent if the useful life is 3 or 4 years and 6⅔ percent if the useful life is 5 or 6 years.) A commuter highway vehicle is defined as a highway vehicle with a useful life of at least 3 years, which seats at least 8 adults (excluding the driver), and which reasonably may be expected to be used for at least 80 percent of its mileage to transport a taxpayer's employees between their homes and places of work on trips during which employees occupy at least one-half of the seating capacity of the vehicle. If less than 80 percent of the mileage use of a commuter highway vehicle meets these requirements during the first 3 years of operation, then an appropriate amount of the credit is recaptured (sec. 47(a)(4)(B)) by redetermining the investment credit under the general rule relating to useful lives. The credit is available for vehicles purchased after November 8, 1978, and placed in service by the taxpayer before January 1, 1986. When an employer uses leased vehicles to provide rides, the regular investment credit for such vehicles is allowed to the owner of the vehicles, rather than to the employer, under the general investment credit rules. The investment credit for a commuter highway vehicle is not allowed to a nonbusiness individual.

*Inclusion in gross income of value of employer-provided transportation*

Subject to certain conditions, the gross income of an employee does not include the value of transportation in a commuter highway vehicle which is provided by his employer (sec. 124). However, under the general rules of section 61, amounts received by employees as reimbursement for otherwise nondeductible personal expenses must be included in gross income. Similarly, gross income includes amounts recived as compensation for services (sec. 61(a)(1)), and would include amounts received by a driver for rides.

*Treatment of taxes on motor fuels*

Prior to the enactment of the Revenue Act of 1978 (Pub. L. 95–600), an individual who itemized deductions could deduct State and local (but not Federal) taxes imposed on gasoline, diesel fuel, and other motor fuels not used in business or investment activities. The 1978 Act repealed the itemized deduction for these taxes. Increases in the cost of any motor fuel which results from Presidential action to adjust imports under section 232(b) of the Trade Expansion Act of 1962, as amended,[1] would not result in any deduction for nonbusiness taxpayers since no provision authorizes such a deduction. To the extent that Federal, State or local taxes are imposed on motor fuels used in a taxpayer's trade, business or investment activity, they generally are deductible as ordinary and necessary business expenses or as expenses incurred in a profit seeking activity (secs. 162 and 212). Similarly, import fees imposed by the President under section 232(b) of the Trade Expansion Act of 1962, as amended, to increase the sales price of such a fuel, would be deductible under the same provisions of present law.

***Issues***

The principal issues raised by the bill are, (1) whether and in what amount a nonbusiness individual should be allowed an income tax credit for the purchase of a vehicle used for ride-sharing; (2) whether an employee's gross income should include the value of commuting between home and work on public transportation, when the employer pays for such trips; (3) whether a commuter highway vehicle should be energy property, eligible for the business energy investment credit in addition to the regular investment credit; (4) whether a leased vehicle should qualify as a commuter highway vehicle and thus be eligible for the full investment credit; (5) whether an employer should be entitled to a new income tax credit for administrative costs of a ride-sharing program provided for employees; and (6) whether an itemized deduction for nonbusiness taxpayers should be allowed for certain taxes imposed on motor fuels which are used in a ride-sharing vehicle.

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[1] Section 232(b) of the Trade Expansion Act of 1962, as amended, authorizes the President to adjust oil imports, but eliminates that authority whenever a Joint Resolution is enacted which disapproves such executive action. Oil import adjustments may take the form of an increase in the price of petroleum and petroleum products.

### *Explanation of the bill*

*Title I: Individual Income Tax Credit*

Title I of the bill would entitle a nonbusiness individual to a nonrefundable 15-percent income tax credit for the purchase of a new commuter highway vehicle. For this purpose, a highway vehicle would qualify as a commuter highway vehicle if it seats at least 8 adults (excluding the driver), is not used in a trade or business and will be used to at least 50 percent of its seating capacity (excluding the driver) for at least 50 percent of its mileage to transport individuals between their homes (or gathering ponnts) and work. The bill provides that such a vehicle is not considered to be used in a trade or business if the vehicle is not generally available to the public and the taxpayer otherwise would travel from home to work over the same or similar route even if other individuals were not transported to work by the taxpayer.

In the case of a jointly acquired vehicle, the credit would be apportioned among its owners according to their respective shares of its cost. The credit would be recaptured if, during the 3-year period beginning on the date of acquisition of a vehicle, the vehicle is disposed of (except by reason of death) or ceases to be used as a qualified commuter highway vehicle.

*Title II: Exclusion of Qualified Transportation Income from Gross Income*

Title II of the bill would exclude from an employee's gross income amounts received from the employer for trips between home and work which are made on public transportation. Such trips must be on land or water in a vehicle or vessel which seats at least 8 adults (not including the operator). In addition, the bill would exclude from an employee's gross income any employer-provided services in connection with a "ride-sharing program." A "ride-sharing" program would be any program to assist employees in locating other employees to share transportation between the employees' residences or gathering points and places of employment. Ride-sharing services would include amounts contributed by the employer, compensation paid to any employee who operates or assists in a ride-sharing program, computer services provided by the employer and certain other services.

The bill also would exclude from an individual's gross income compensation received from other individuals for transporting them between their homes and places of work. This latter exclusion would be limited to an individual who owns a motor vehicle which seats fewer than 16 adults, does not make that vehicle generally available to the public and would commute between home and work even if no other persons were being transported.

*Title III: Business Energy Investment Credit*

Title III of the bill would define a commuter highway vehicle to be energy property and would allow a 10-percent energy investment credit to businesses for such vehicles purchased after December 31, 1980, and placed in service before January 1, 1986. Thus, for a business the energy investment credit and the regular investment credit would total 20 percent of the cost of a vehicle.

In addition, the bill would expand the present law definition of commuter highway vehicle to include such vehicles without regard to whether the riders are the taxpayer's employees. Thus, under the bill, the 10-percent energy investment credit and the 10-percent regular investment credit would be allowed to a business which purchases a vehicle and leases it for use as a commuter highway vehicle to a second entity. The bill specifically provides that if an individual other than the taxpayer is the regular driver of a highway vehicle, the regularly scheduled driver's personal use of the vehicle will not be considered in determining whether 80 percent of the mileage use of the vehicle is used as a commuter highway vehicle.

*Title IV: Employer Tax Credit for Qualified Ride-Sharing Programs*

Title IV of the bill would allow a new income tax credit to an employer who operates a "qualified ride-sharing program." A qualified program is defined by the bill as a program to assist employees in obtaining qualified transportation between their homes and place of work. Qualified transportation is defined by the bill to mean transportation (1) by a commuter highway vehicle, (2) by scheduled public transportation along regular routes on land or water in a vehicle or vessel which seats at least 8 adults (not including the operator), or (3) by any highway vehicle which seats less than 8 adults and which is used for transporting an average of at least 3 employees between their homes and places of employment for a minimum number of days (the lesser of (a) 176 days during the calendar year in which the taxable year begins, or (b) one-half of the days on which the taxpayer held the vehicle during the calendar year). In addition, a "qualified ride-sharing program" would have to be set forth in a separate written plan (non-discriminatory as to employees who are officers, shareholders, or highly compensated employees) providing for at least one qualified ride-sharing service. Such services would include—

(a) the surveying of employees to determine current commuting patterns and interest in qualified transportation,

(b) the distribution of informational material on the advantages and availability of qualified transportation,

(c) contracting for assistance in establishing, sponsoring, or operating a qualified ride-sharing program,

(d) providing assistance (including computer costs) for employee matching to establish carpools or vanpools,

(e) assessing the impact of qualified ride-sharing programs,

(f) signing or improving parking spaces reserved for qualified transportation vehicles,

(g) adjusting working hours for employees participating in a qualified ride-sharing program,

(h) providing liability insurance for qualified transportation vehicles,

(i) providing emergency or business vehicles for the use of employees (during normal working hours) who commute to work in qualified transportation vehicles, and

(j) such other services as the Secretary, after consultation with the Secretary of Transportation, determines contribute to the effectiveness of the qualified ride-sharing program.

The amount of credit would be equal to the lesser of the employer's cost of operating the ride-sharing program (not including costs incurred for the acquisition and maintenance of vehicles, fuel to operate the vehicles, or mass transportation fares or subsidies) or the amount determined under the formula provided in the bill. The amount determined by formula would be equal to the product of the average number of employees of the employer during the taxable year, multiplied by the appropriate amount from the following table:

| *If the percentage of employees participating in the program is:* | *The amount is:* |
|---|---|
| 0 to 14 percent | $00.00 |
| 15 to 19 percent | 5.00 |
| 20 to 24 percent | 7.50 |
| 25 to 29 percent | 10.00 |
| 30 to 34 percent | 12.50 |
| 35 to 39 percent | 15.00 |
| 40 to 44 percent | 20.00 |
| 45 to 49 percent | 25.00 |
| 50 or more percent | 30.00 |

For example, if 200 persons work at a place where a qualified ride-sharing program is in operation and 50 of these persons (i.e., 25 percent of the work force) participate in the program, then the amount of credit determined by formula is $2,000 (that is, 200 multiplied by $10).

*Title V: Gasoline Tax Deduction*

Title V of the bill would allow an itemized deduction for "qualified motor fuel taxes." The term qualified motor fuel taxes would be defined to be Federal, State or local taxes imposed on sales of gasoline, diesel fuel, and other motor fuels used as a fuel in a "ride-sharing vehicle." Essentially, a ride-sharing vehicle would be defined as one which is eligible (within the meaning of the bill) for the investment tax credit. The term also would include any highway vehicle which seats less than eight adults (excluding the driver) and which is used for transporting an average of at least three employees between their residences and their place of employment for at least the lesser of (1) 176 days during the calendar year in which the taxable year begins, or (2) one-half of the days on which the taxpayer held the vehicle during the calendar year.

For purposes of this motor fuel tax deduction, fuel price increases attributable to Presidential action taken under section 232(b) of the Trade Expansion Act of 1962, as amended, to increase the sales price of petroleum or petroleum products, would be treated as a Federal tax imposed on the fuel.

The bill anticipates that the Secretary would publish tables for use in computing the amount of the qualified motor fuel tax deduction.

***Effective date***

The amendments made by Titles I, II, IV and V of this bill would apply to taxable years which begin after December 31, 1980. The amendments made by Title III of this bill would apply to commuter highway vehicles which are acquired after December 31, 1980.

***Revenue effect***

The revenue estimate for this bill is not yet available but will be furnished at the time of the hearing.

***Prior Congressional consideration***

As reported by the Senate Finance Committee and passed by the Senate, H.R. 3919 (the Crude Oil Windfall Profit Tax Act of 1980) would have allowed a full 10-percent regular investment tax credit (but not the energy investment tax credit) for vans which had a useful life of at least 3 years, were used for vanpooling and were owned by parties other than an employer (e.g., by employees or third parties). This provision was not agreed to by the conference.

During its consideration of H.R. 3919, the Senate rejected an amendment which would have reinstated the itemized deduction for nonbusiness State and local gasoline taxes.

## S. 452—Senator Boren

### Gain on Sale of Stock of Foreign Investment Company

***Present law***

In general, gain on the sale of stock in a corporation is taxed as capital gain. However, pursuant to amendments made to the Code in 1962, gain on the sale of stock in a foreign corporation may be taxed as ordinary dividend income where the foreign corporation is either a controlled foreign corporation (sec. 1248) or a foreign investment company (sec. 1246).

A controlled foreign corporation, or "CFC", is a foreign corporation that is controlled (more than 50 percent stock ownership) by U.S. persons who each own at least 10 percent of the corporation's stock. In general, if a 10-percent U.S. shareholder recognizes gain on the sale of stock in a CFC, that gain will be taxed as ordinary income to the extent of the U.S. shareholder's pro rata share of the CFC's post–1962 earnings and profits that were accumulated while the shareholder owned the stock (sec. 1248).

Prior to 1962, U.S. taxpayers were able to engage in business outside the United States by organizing a foreign corporation which was not subject to U.S. taxation (sometimes referred to as "deferral") and sell the stock of the corporation or liquidate the corporation at capital gains rates. In contrast, a U.S. corporation operating abroad would be required to pay U.S. tax (reduced by foreign tax credits) on its operating income before the sale or liquidation at capital gains rates. In order to eliminate this potential for converting ordinary income of a foreign subsidiary into capital gains, Congress adopted section 1248 which, as described above, taxes 10-percent U.S. shareholders on their gain on the sale of stock in, or the liquidation of, a CFC as ordinary income to the extent of their pro rata share of the CFC's post-1962 earnings and profits which were accumulated while the shareholder held the stock.

An exception to this ordinary income treatment was provided for CFC's that derived most of their income from less developed countries. Thus, gain on the sale or liquidation of stock in a less developed country corporation ("LDCC") would produce capital gains rather than ordinary income under section 1248. This special capital gains treatment for LDCCs was eliminated in the Tax Reform Act of 1976 for post-1975 earnings of LDCCs.

The 1962 Act also contained similar provisions to deal with problems presented by foreign investment companies. Domestic investment companies are generally not subject to tax if they distribute at least 90 percent of their income (usually ordinary income) to their shareholders each year. These shareholders are then taxed at ordinary rates on this pass-through income. Foreign investment companies, on the other hand, were generally not subject to U.S. taxation prior

to the 1962 Act, so they would accumulate and reinvest their earnings free from U.S. tax. This allowed U.S. shareholders to sell their stock in the foreign investment company at capital gains rates even though the sales price reflected these retained and reinvested tax-free earnings.

In order to eliminate the avoidance opportunities presented under prior law by foreign investment companies, Congress adopted section 1246 which provides that gain from the sale or exchange of stock in a foreign investment company by a U.S. person (not limited to 10 percent ownership) would be treated as ordinary income to the extent of the shareholder's pro rata share of the corporation's post-1962 earnings and profits that were accumulated while the shareholder owned the stock. (A foreign investment company is defined as any foreign corporation which is registered under the Investment Company Act of 1940, or which is engaged in certain investment activities under the Act and is controlled by U.S. persons.) However, provision was made in section 1247 for an election whereby section 1246 would not apply to a foreign investment company that annually distributed 90 percent of its income and conformed to other rules similar to those applicable to domestic investment companies.

The tax provisions of section 1248, regarding CFC's, and the tax provisions of section 1246, regarding foreign investment companies, are generally the same. However, taxation under section 1246 is stricter in several respects. First, it applies to all U.S. persons who are shareholders in the corporation, not just to 10 percent U.S. shareholders. Second, no exception was provided under section 1246 for LDCC stock as was the case under section 1248 for earnings derived prior to 1976. Finally, section 1246 applies to all post–1962 earnings of a foreign corporation even if the corporation was a foreign investment company for only one day, whereas section 1248 only applies to the post–1962 earnings of a foreign corporation for those periods that it was a CFC. Thus, for example, if, in 1980, a U.S. shareholder sold stock in a foreign corporation which was organized in 1963 and which engaged in activities that made it a foreign investment company for part of one year, say, 1970, the sale would be taxed under section 1246 as though it were a foreign investment company for the entire 17 years rather than just the one year. This result would obtain even though the foreign corporation was not a CFC for the other 16 years or, even if it were a CFC for those years, its income was not subject to section 1248 (e.g., it was an LDCC for those years), so that the U.S. shareholder's gain on the sale of the stock would have otherwise been capital gains income.

### *Issue*

The issue is whether gain from the sale of stock in a foreign corporation attributable to earnings and profits from the period before the corporation became a foreign investment company should be treated as ordinary income.

### *Explanation of the bill*

The bill would provide that gain on the sale of a foreign corporation's stock will not be taxed under section 1246 with respect to earnings and profits of the corporation attributable to years before the corporation became a foreign investment company. This change would

prevent gain attributable to active business operations from being taxed under the foreign investment company provisions if the corporation subsequently becomes a foreign investment company. Thus, under the previous example, the gain from the sale of the corporation's stock which is attributable to years prior to 1970 would not be treated as ordinary income under section 1246. That gain would be taxed based upon the foreign corporation's status for those earlier years without regard to its subsequent qualification as a foreign investment company. Thus, if the corporation were not a CFC for the earlier years, or if it were a CFC, but it was exempt from the application of section 1248 because, for example, it was an LDCC for those years, the gain might be taxed at capital gains rates if it otherwise qualified. However, gain attributable to 1970 and all later years would be subject to the provisions of section 1246.

***Effective date***

The bill would apply to sales or exchanges after the date of enactment of the bill in taxable years ending after that date.

***Revenue effect***

It is estimated that this bill would reduce budget receipts by $5 million in fiscal year 1981 and by less than $1 million annually in later years.

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