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TAX REFORM BILL OF 1974

Press Release Descriptions of Tentative Decisions Corresponding to Sections of Draft Bill

TITLE II—CHANGES PRIMARILY AFFECTING CORPORATIONS

PREPARED FOR THE USE OF

THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

BY

THE STAFF

OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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TITLE II—CHANGES PRIMARILY AFFECTING CORPORATIONS

Part I—Tax Treatment of Small Business

Sec. 211. Changes in additional first-year depreciation allowance for small business.

With respect to the additional first-year depreciation allowance, the committee agreed to:

a. increase the dollar limit on the amount of property which may qualify for the allowance from $10,000 to $15,000 ($30,000 on a joint return); and

b. eliminate the requirement that the property eligible for the allowance have a useful life of 6 years or more.

Sec. 212. Increase in minimum accumulated earnings credit from $100,000 to $150,000

The amount of earnings a corporation may accumulate without the imposition of the accumulated earnings tax is to be increased from $100,000 to $150,000.

Sec. 213. 10-year carryover of net operating losses incurred during first 10 years of operation.

In the case of new businesses, the period over which net operating losses may be carried is to be increased from 5 years to 10 years during the first 10 years of operation.

Sec. 214. Closing of partnership taxable year on death of partner.

The successor in interest of a deceased partner may elect to close the taxable year of the partnership with respect to the interest of the deceased partner as of the date of his death, instead of waiting until the close of the partnership taxable year or the date his interest is sold, exchanged, or liquidated.

Sec. 215. Changes in provisions relating to subchapter S corporations.

The committee also agreed to four changes dealing with subchapter S (the election of certain small business corporations not to be taxed as corporations). These tentative decisions are as follows:

a. Increase in number of shareholders.—The maximum number of shareholders which a subchapter S corporation may have is to be increased from 10 to 15.

b. Certain trust ownership.—In three types of situations trusts will be permitted to be qualified shareholders in subchapter S corporations: in the case of (1) voting trusts; (2) grantor trusts (where the grantor is treated as the owner for tax purposes); and (3) instances where the holding by the trust is only temporary (e.g., where it passes through a residuary trust to individual beneficiaries):

c. Estate of deceased spouse not to be treated as shareholder.—When subchapter S stock has been held by a husband and wife, the estate of one of the spouses will not be considered a shareholder for purposes of determining the number of shareholders of the subchapter S corporation.

d. New shareholders must affirmatively elect to terminate election.—A subchapter S election is to be terminated only upon a new shareholder's affirmative refusal to consent to a continuation of the subchapter S election (instead of upon the failure of a new shareholder to consent to the election).

Part II—Certain Accounting Changes

Sec. 221. Accrual of vacation pay.

A permanent solution for the treatment of accrued vacation pay is provided to allow an employer to take a deduction in the case of accrued vacation pay which, except for contingencies (such as termination of employment before vacation time arrives), has already been earned by the employees. However, to prevent a doubling up of deductions in the case of an employer who is not covered by the provisions relating to accrued vacation pay in the Technical Amendments Act of 1958, if the employer elects to take deductions under this new provision for accrued vacation pay, he may not currently take a deduction for payments of the contingent amounts which accrued (on this basis) in years prior to the year in which the employer elects this treatment. This amount is held in suspense and is available as a deduction only to the extent that the end of the year liability for accrued vacation pay (on the new basis) is less than the beginning amount held in the suspense account.

These provisions are effective for taxable years beginning after January 1, 1973.

Sec. 222. Income attributable to magazines which are returned.

Magazine publishers often distribute to retail distributors more copies of a magazine than is anticipated the retailer can sell to assure them an adequate number of copies for display purposes. When the next issue of the magazine is distributed to the retailer, the retailer will return the unsold copies of the magazine (or parts of them) to the publisher.

The committee agreed to allow an adjustment in a taxable year for magazines distributed in that year which were returned to the publisher in the succeeding year. The provision would allow the adjustment to be made only for the returns actually made or returns the taxpayer knows have been made within 75 days after the end of the year. This provision is to apply after the date of enactment of the bill and is not intended to infer what constitutes the proper treatment under present law.

Sec. 223. Tax treatment of installment obligations disposed of to a life insurance company.

The committee agreed to repeal the rule in present law that if installment obligations are transferred to a life insurance company, the nonrecognition provisions of the Code are not to apply and the transferor is to be taxed on the unrecognized gain on the installment obligations.

The committee also agreed to a conforming change to make it clear that the installment obligation income is to be subject to tax to the life insurance company as taxable investment income (or as long-term capital gain).

Sec. 224. Tax treatment of face-amount certificates.

Presently, the Internal Revenue Service regulations require that in the case of a face-amount certificate issued by a corporation after December 31, 1974, the amount of any original issue discount attributable to the certificate must be included in the gross income of the holder on a pro rata basis over the life of the certificate. According to the regulations, the amount that must be ratably included in gross income is the difference between the amount paid for the certificate by the purchaser and the amount received by him at maturity.

The committee tentatively decided that in the case of a face-amount certificate issued by a corporation, the amount of any discount is to be included in the taxpayer's gross income only at the time of sale, exchange, or other disposition of the certificate (or redemption by the issuer). However, the issuing corporation in these cases would not be allowed to deduct the amount of the discount until it was actually paid to the holder of the certificate.

Part III—Amortization

Sec. 231. Extension of period during which pollution control facilities, railroad rolling stock, rehabilitation housing, and coal mine safety equipment may qualify for 5-year amoritzation.

The committee agreed to extend four provisions that provide 60-month amortization beyond their present December 31, 1974, expiration date. These provisions were included in the Tax Reform Act of 1969 for certain activities because the investment tax credit was repealed in that Act. Rapid amortization is not available, however, if the taxpayer takes the reenacted investment tax credit (except in the case of certain railroad property).

The committee extended the applicability of rapid amortization three more years (until December 31, 1977) in the case of two of these provisions:

(1) Rehabilitation of low income rental housing (section 167 (k)) subject to certain structural changes; and

(2) Certified pollution control facilities (section 169) installed in a plant that was in operation before January 1, 1974.

In the case of the provision providing for rapid amortization for railroad locomotives and freight cars (section 184), the extension is for five years and in the case of coal mine safety equipment (section 187) the extension is for one more year, or until December 31, 1975.

Sec. 232. Amortization over 50-year period of railroad grading and tunnel bores placed in services before 1969.

Railroad grading and tunnel bores that were placed in service before 1969 may be amortized over a 50-year period. This provision is available to domestic railroad common carriers at their election. A similar provision was enacted in the Tax Reform Act of 1969 but covered only railroad grading and tunnel bores placed in service after 1968.

Sec. 233. Amortization of certain railroad equipment.

Expenditures for the construction, installation, or erection of electronic classification yards, equipment for handling trailers and containers, and communications and signal equipment will be eligible for 60-month amortization. This provision is in addition to the 60-month amortization for locomotives and freight cars.

Part IV—Investment Credit

Sec. 241. Increase in amount of investment credit for property used for furnishing or sale of electrical energy or gas through a local distribution system.

The committee tentatively decided that the investment credit for property used predominantly in the trade or business of the furnishing or sale of electrical energy or gas to a local distribution system is to be increased from 4 to 7 percent. The increase in the amount of investment credit is to be available, however, only if the State regulatory commission does not require the savings to be passed through by the utility to the customer.

Sec. 242. Investment credit to be available for railroad rolling stock eligible for amortization.

The 7-percent investment tax credit will be available for all of the types of railroad investment eligible for 5-year amortization. Taxpayers under present law may not take the investment credit and rapid amortization for the same equipment.

Sec. 243. Investment credit in the case of movie and television films.

Prior to 1971, it was not clear whether (and if so, under what conditions) the investment credit was available for movie or television films. A court case held that movie films were tangile personal property eligible for the investment credit. In the Revenue Act of 1971, it was made clear that motion pictures and television films are to be treated as tangible personal property which is eligible for the investment credit (*i.e.*, section 38 property). However, there still are important unsettled issues, such as how to determine useful life, the basis on which the credit is computed, and how to determine whether use is predominantly within the United States.

The committee decided to provide different methods to deal with the problems of the proper treatment of the investment credit for motion pictures and television films with respect to the past and with respect to the future.

For the past, one of two alternatives would be available. The first method available for the past is what in most respects has been the IRS litigation position. A taxpayer under this method would be eligible to receive the full credit (or any partial credit) for their films if it is demonstrated on a film-by-film basis that the film satisfied both the useful life requirement and the requirement that there must be no predominant foreign use. For purposes of the useful life test, the useful life of the film is to be treated as ending at the end of the first year in which for depreciation purposes it was estimated that 90 percent or

more of the depreciable cost of the film would be recovered. For purposes of the predominant foreign use test, a film is to be treated as used predominantly in foreign markets if, in any year (and not on a cumulative basis), more than 50 percent of the gross revenues from the film resulted from showing the film abroad.

A second alternative method is also to be available for prior years. This method may be elected by a taxpayer for all years prior to 1975 (with respect to which an investment credit was available) or only with respect to years prior to the reenactment of the investment credit on August 15, 1971. If this method is elected, unused investment credits may not be carried over from years in which this method is used to any subsequent years in which any other method of determining the investment credit is used.

Under this second alternative, a taxpayer may elect to take an investment credit on the basis of 40 percent of the cost of all of his films without regard to the estimated useful life of the film for purposes of depreciation and also without regard to whether the film is shown predominantly outside of the United States. Under this method, the credit would be based on the total cost of production, including capitalized production costs, a reasonable allocation of general overhead costs, salaries paid to the actors and production crew, costs of "first" distribution of prints, and the cost of the story being filmed. The cost for this purpose would include so-called residuals, but in the case of participations with respect to actors or others, it would include only those which are guaranteed. Films such as news features which are essentially transitory in nature, as well as films which are produced and shown exclusively in foreign countries, would not be eligible for the credit.

For future years, taxpayers could elect to take an investment credit on a two-thirds basis for all films (instead of determining useful life on a film-by-film basis).

Also for the future, the availability of the investment credit would not depend on whether the film was predominantly used within the United States or in foreign countries; instead, the amount of the credit would depend on where the film is produced, rather than where receipts are derived from the showing of the film. For this purpose, however, films, such as news features, which are essentially transitory in nature, would not be included in the base on which the two-thirds credit is computed.

If 80 percent or more of the direct production costs of a film are incurred in the United States, a taxpayer would be entitled to an investment credit (on the same credit base as indicated above under the 40-percent-method with respect to prior years), except that the credit base would not include direct expenses for foreign production or for salaries paid for services performed abroad (unless in this latter case the salaries were paid to U.S. persons and were subject to U.S. tax). In determining whether this 80-percent-test is met, however, only direct costs of production will be taken into account. (Overhead costs and the costs of screen rights, for example, for this purpose would not be taken into account.)

If less than 80 percent of the production costs are incurred for U.S. production, a taxpayer could still receive a credit to the extent of *direct* U.S. production costs. The credit base in this case, however, would not include such items as general overhead costs or costs of acquiring screen rights or any costs of foreign production, except for salaries paid to U.S. persons subject to U.S. tax.

The committee also agreed that the investment credit should be available in the case of films to the persons who bear the risk of loss if the film is not a successful picture. This rule applies under any of the alternatives set forth above.

Part V—Industrial Development Bonds

Sec. 251. $10,000,000 lifetime exemption from industrial development bond provision.

The committee agreed to raise the limit on the small issues of industrial development bonds that qualify for tax-exempt status. Under present law, the limits on these small issues are $1 million on the face amount of the bond issue in any one year or $5 million on the total cost of the facility incurred over a 6-year period.

The committee action raised the ceiling on small issues to $10 million and limited it to a maximum lifetime amount for each corporation and all its affiliates. In addition, the committee agreed to eliminate the 6-year capital expenditure rule so that a corporation may use private financing to expand a facility that was constructed initially with funds raised by a tax-exempt industrial development bond issue.

Sec. 252. Limitation on amount of expenditures which can be treated as pollution control facilities for purposes of the exemption to the industrial development bond provision.

The committee also agreed to limit the availability of industrial development bonds for air and water pollution control facilities. Under present law, there is no restriction on the amount of an issue that may be used for the construction of new air and water pollution control facilities. The committee tentatively decided to limit the coverage of industrial development bonds for pollution control facilities to 10 percent of the cost of a new facility.

Part VI—Bank Holding Companies

Sec. 261. Distributions pursuant to Bank Holding Company Act Amendments of 1970.

The committee tentatively agreed to provisions dealing with the income tax treatment of divestitures of either bank or nonbank assets by bank holding companies required by the Bank Holding Company Act Amendments of 1970.

The committee's tentative decision provides for two possible ways in which tax relief can be obtained for a divestiture by individuals and corporations made pursuant to the 1970 bank holding company legislation. Both of these methods would be available with respect to assets acquired by the bank holding company on or before July 7, 1970. The first method provided by the committee provides for the stock of the bank or nonbank corporation to be distributed tax free to the shareholders of the bank holding company. The committee intends that this treatment be essentially the same as that provided in connection with the 1956 and 1966 bank holding company divestiture legislation. The "spin-off" treatment would be available with respect to stock distributions occurring after July 7, 1970.

Sec. 262. Installment payment of tax.

The second method provided by the committee's tentative decision would permit a bank holding company selling either bank or nonbank property to pay the tax on the gain realized on the sale in equal annual installments over a period beginning in the year after the disposition and ending no later than 1985. In order to have the installment payment provision available for the capital gains tax, the selling company must reinvest the proceeds less the tax liability of the divestiture sale in business assets or in stock of a controlled corporation. The bank holding company may be required to furnish a bond in the amount of the tax due. This method would be available for sales of assets acquired before July 7, 1970, made after such date. The installment payment of tax is also to be available in certain situations where the divestiture is compelled by State law.

Part VII—Real Estate Investment Trusts

Sec. 271. Deficiency dividend procedure.

The committee agreed to the provision establishing a deficiency dividend procedure which would allow a REIT that fails to meet the income distribution requirements upon an audit by the IRS to make a late distribution to its shareholders to avoid disqualification. This procedure would only be available if the REIT initially missed the 90-percent distribution requirement for reasonable cause. The REIT would be subject to interest and penalties on the amount of the adjustment.

Sec. 272. Trust not disqualified in certain cases where income tests were not met.

A REIT that fails to meet the income source test upon audit by the IRS would not be disqualified but would be allowed to pay tax on the amount by which it failed to meet the source tests. This provision would be available only if the REIT initially had reasonable ground to believe and did believe that it met the income source tests.

Sec. 273. Treatment of foreclosure property and property held for sale to customers.

A REIT would not be disqualified because of income it receives from foreclosure property since the REIT should not be held responsible for the type of lease or other transaction entered into by its mortgagee. At the election of the REIT, a 2-year grace period (generally subject to 2, one-year extensions) would be afforded so that the REIT could liquidate the foreclosed property in an orderly manner. The REIT would pay corporate tax on the nonqualified income on the property received from foreclosure during the grace period.

A REIT would be permitted to hold a limited amount (up to one percent of its gross income) of property for sale to customers but this income would be subject to corporate tax. Any income in excess of one percent would be subject to an additional tax rather than disqualify the REIT, provided that the REIT had reasonable ground to believe that the excess income would not be determined to be from such sources.

Sec. 274. Other changes in limitations and requirements.

Certain types of income which customarily are earned in a real estate business which do not presently qualify under the income source test for a REIT are to be treated as qualifying income. These include (a) certain rents from personal property leased together with real property; (b) charges for services customarily furnished in connection with the rental of real property whether or not such charges are separately stated; and (c) commitment fees received for entering into

agreements to make loans secured by real property. Since in view of these and other changes a significant portion of income is to be removed from the category of nonqualified income, the income source requirements are increased so that nonqualified income could be only 5 percent of gross income (rather than the present 10 percent). Also a corporate tax will be imposed on nonqualified income at the REIT level.

A REIT would be permitted to operate in corporate form. (Under present law a REIT must operate as a trust or association.)

Other changes are also to be made concerning technical rules applicable to REITs, such as, those concerned with income from sales of mortgages held for less than 4 years and options to purchase real property.

Any interest that depends in whole or in part on income or profits is not to be treated as qualifying interest.

Sec. 275. Excise tax.

In view of the proposed deficiency dividend procedure, the committee agreed to encourage prompt dividend distributions by modifying the present rule dealing with dividends paid by a REIT after the close of the taxable year to require a 3-percent charge on the amount by which a REIT actually distributes less than 75 percent of its income in the year received. Also, a new REIT would be required to be on a calendar year.

Part VIII—Cooperative Housing Associations

Sec. 281. Tax treatment of certain cooperative housing associations.

The committee tentatively agreed to provide that in the case of homeowner associations, condominium housing associations, and cooperative housing corporations, only the investment income and income derived from a trade or business is to be taxable. A deduction would be allowed for expenses directly attributable to any investment income and any income derived from a trade or business. Assessments for the administration, maintenance and operation of the homeowners association, etc., would not be taxable.

Part IX—Other Changes

Sec. 291. Transfers of section 1245 property or section 1250 property to tax-exempt organization which uses such property in an unrelated trade or business.

Under present law, there is no recapture of depreciation under section 1245 in the case of certain tax-free transactions of property where the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor. However, this rule does not apply to a disposition of property to an organization (other than a cooperative as described in section 521) which is exempt from Federal income tax.

The committee tentatively decided to provide that depreciation would not be recaptured under section 1245 in any case where property is disposed of in tax-free transactions to an organization exempt from Federal income tax if the property is used by the transferee in an unrelated trade or business. However, if the property ceases to be used in an unrelated trade or business, then, this property is to be treated as being disposed of by the transferee on the date it ceases to be so used.

Sec. 292. Distribution deduction for certain cemetery perpetual care fund trusts.

Under present law, the IRS has taken the position that cemetery perpetual care funds established by a taxable cemetery are subject to tax since they are discharging an essential function of the profit-making cemetery corporation; that is, maintaining the cemetery, burial lots and crypts.

The committee has agreed to provide a special deduction in computing income of a cemetery perpetual care fund for amounts paid or expended by the fund for the care and maintenance of cemetery property in which internment rights have been sold. The amount of this deduction is to be limited to the maximum of $5 times the aggregate number of cemetery grave sites which have been sold. This provision is to be effective from 1964, the year in which the IRS first gave public notice of its position regarding the tax treatment of cemetery perpetual care funds.

Sec. 293. Player contracts in case of sports enterprises.

In the case of sports enterprises, the committee tentatively agreed to specify clearly the portion of an aggregate amount paid to purchase a team or group of assets which is allocable to player contracts. The committee tentatively agreed to specify that the amount allocable to player contracts by a purchaser could not exceed the amount of the sales price allocated to such contracts by the seller. In addition, the committee decided to provide specifically in the law a rule now in the regulations; namely, that the price allocated to the sale of player contracts, to the extent of any amount previously allocated to these player contracts, is to result in ordinary income (to the extent of the gain).

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