

DESCRIPTION OF TAX BILLS
LISTED FOR A HEARING
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY
OF THE
COMMITTEE ON FINANCE
ON OCTOBER 31, 1979

PREPARED FOR THE USE OF THE
COMMITTEE ON FINANCE
BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on October 31, 1979, by the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee.

The pamphlet first briefly summarizes the bills. This is followed by a description of each bill, setting forth present law, the issues involved, an explanation of the provisions, the effective dates, and the estimated revenue effects. Also, there is included an indication of prior Congressional action with respect to the subject of the bill. The summary and description of the bills are in the numerical order of the bills listed for the hearing except that S. 246, S. 1488, and S. 1846, are presented in sequence because these bills relate to the exclusion of interest income.

The bills described in the pamphlet are :

(1) S. 246 and S. 1488 (relating to partial exclusion of interest received by individuals).

(2) S. 1846 (relating to partial exclusion of interest and dividends received by individuals).

(3) S. 541 (relating to estate tax alternate valuation).

(4) S. 555 (the Independent Local Newspaper Act of 1979).

(5) S. 999 (relating to interest on underpayments of tax).

(6) S. 1543 (relating to dividend reinvestment plans).

(7) S. 1638 (relating to amortization of business startup costs).

(8) S. 1703 (relating to the tax treatment of employees of charities working abroad).

I. SUMMARY

1. S. 246—Senator Bentsen; S. 1488—Senator Nelson

Partial Exclusion of Interest Received by Individuals

Generally, under present law, interest income is subject to Federal income taxation.

The bill, S. 246, would provide an exclusion for the first \$500 (\$1,000 for a husband and wife who file a joint return) of interest earned by an individual on a savings account at a bank, saving and loan association, or a credit union.

The bill, S. 1488, would provide an exclusion from gross income for the amount that eligible interest received by an individual for the taxable year exceeds the amount received for the preceding taxable year. The exclusion would be limited to \$500 for each individual taxpayer with respect to deposits or accounts with banks and savings and loan associations (other than money market certificates or negotiable rate accounts).

2. S. 1846—Senator Talmadge

Partial Exclusion of Interest and Dividends Received by Individuals

Under present law, the first \$100 of dividends received by an individual from domestic corporations is excludable from gross income. No exclusion is provided for interest received by an individual with respect to savings accounts.

The bill would extend the present dividend exclusion to interest received by an individual on certain savings accounts and increase the total amount excludable to \$250 (or \$500 in the case of a joint return).

3. S. 541—Senators Baker and Sasser

Election of Estate Tax Alternate Valuation

Under present law, an executor may elect to value assets for estate tax purposes as of the date of the decedent's death or the alternate valuation date which is generally six months after the decedent's death. Alternate valuation must be elected on an estate tax return that is timely filed.

The bill would permit an executor to elect alternate valuation on a timely filed estate tax return or, if no estate tax return is timely filed, on the first estate tax return filed.

Generally, the bill would apply with respect to estates of decedents dying after December 31, 1977. For estates of decedents dying on or before that date, the bill would apply only if an election had been attempted in the first estate tax return filed and if the executor elects the provisions of the bill within 90 days after enactment of the bill.

4. S. 555—Senators Morgan, Baker, Sasser, Percy, Inouye, Schmitt, Mathias, Riegle, McGovern, Ford, Cohen, Pell, Helms, Pressler, Durkin, Cochran, Levin, and Stewart

The Independent Local Newspaper Act of 1979

The bill would allow independent local newspapers to establish tax-exempt trust funds in order to pay the estate taxes of the owners of the paper. Contributions to the trust by the paper would generally be deductible in computing income tax, and interests in the trust would be exempt from the estate tax. In addition, the bill would provide an extended payment period for estate taxes attributable to interests in independent local newspapers.

5. S. 999—Senators Bentsen and Cochran

Interest on Underpayment of Tax

Under present law, interest is payable where the amount of any tax is not paid on or before the last day prescribed for its payment. The bill would excuse the payment of interest due with respect to an underpayment of tax if the failure to pay was due to reasonable cause and not to willful neglect.

6. S. 1543—Senators Nelson and Bentsen

Dividend Reinvestment Plans

Under present law, stock dividends received by shareholders generally are nontaxable. However, a stock dividend is treated as a taxable dividend distribution if the shareholder has the option of receiving cash or other property or, in certain cases, the distribution of stock is disproportionate among shareholders.

The bill would provide an option to exclude from gross income the value of common stock received by a shareholder under a dividend reinvestment plan. The amount excludable annually would be limited to \$1,500 (\$3,000 in the case of a joint return).

7. S. 1638—Senator Roth

Amortization of Business Startup Costs

Under present law, costs incurred prior to the commencement of a business normally are nondeductible expenses because they are not incurred in carrying on a trade or business. These startup or pre-opening costs must be capitalized and often cannot be depreciated or amortized because no ascertainable useful life can be established for these costs. However, the capitalized costs may be recovered for purposes of measuring gain or loss upon the disposition or cessation of the business.

The bill would allow an elective 60-month amortization period for certain ordinary and necessary business startup costs which are incurred incident to the investigation, formation, or creation of a trade or business entered into by the taxpayer.

8. S. 1703—Senators Chafee, Cochran, Matsunaga, Moynihan, Jepsen, Ribicoff, Boren, Long, Cranston, Mathias, Wallop, Talmadge, Hatfield, and Baucus

Tax Treatment of Employees of Charities Working Abroad

The bill would allow employees of charitable organizations working abroad to exclude up to \$20,000 of foreign earned income annually on the same basis as is now afforded to employees working in camps in hardship areas.

II. DESCRIPTION OF BILLS

1. S. 246—Senator Bentsen; S. 1488—Senator Nelson

Partial Exclusion of Interest Received by Individuals

Present law

Under present law, interest earned on savings accounts is subject to Federal income taxation.

Issue

The principal issue is whether some portion of the interest received by individuals on savings accounts should be excluded from gross income.

If it is decided that a partial exclusion for interest received should be provided, other issues relate to the amount to be excludable and to the types of savings deposits or accounts the interest on which would be eligible for exclusion from gross income.

Explanation of the bills

S. 246

Under the bill, a limited amount of interest received by an individual on certain time or demand deposits would be excludable from gross income. The amount excludable would be limited to \$500. In the case of a husband and wife who file a joint return, the excludable amount would be limited to \$1,000.

Interest eligible for the exclusion would be amounts received on a time or demand deposit with a commercial or mutual savings bank, a savings and loan association, building and loan association or similar association, and a credit union. However, interest on these deposits would be eligible for the exclusion only if the deposits and accounts of the institution are insured by either the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, the National Credit Union Administration Share Insurance Fund, or are otherwise insured in accordance with the requirement of the law of the State in which the institution is located.

S. 1488

Under this bill, interest received by an individual on certain savings deposits and withdrawable savings accounts would be excludable only to the extent the amount of qualifying interest received for the taxable year exceeded the amount received for the preceding taxable year. In addition, the amount eligible for exclusion by an individual would be limited to \$500.¹ In the case of a husband and wife, each spouse would be entitled to a separate exclusion for interest received on deposits or accounts belonging to that spouse.

In general, interest eligible for the exclusion would be amounts received on a time or demand deposit with a commercial bank, mutual savings bank, savings and loan association, building and loan association, or a similar association. However, interest received on a money market certificate, or an account for which the rate of interest is negotiable, would not be eligible for the exclusion.²

Effective date

The provisions of S. 246 would apply to taxable years beginning after December 31, 1978. The provisions of S. 1488 would apply to taxable years beginning after December 31, 1979.

Revenue effect

The bill, S. 246, would reduce budget receipts by \$4,161 million in fiscal 1980, by \$3,940 in fiscal 1981, by \$4,230 in fiscal 1982, by \$4,203 in fiscal 1983 and by \$4,474 in fiscal 1984.

¹ As introduced, the bill would have imposed a \$100 limit on the proposed interest exclusion. The bill's sponsor, Senator Nelson, has introduced an amendment to the bill which would set the dollar limit at \$500. (Printed amendment no. 554, filed October 24, 1979.)

² This exception is contained in the amendment offered by the bill's sponsor on October 24, 1979. (Printed amendment no. 554, filed October 24, 1979.)

The bill, S. 1488, would reduce budget receipts by \$107 million in fiscal 1980, by \$776 million in fiscal 1981, by \$833 million in fiscal 1982, by \$896 million in fiscal 1983 and by \$894 million in fiscal 1984. (These estimates reflect the \$500 limit proposed by Senator Nelson in his amendment No. 554, of October 24, 1979.)

Prior Congressional action

In 1974, the Ways and Means Committee reported a bill (H.R. 16994) which provided an exclusion for interest on savings accounts of \$500 for an individual (\$1,000 in the case of a joint return). No floor action was taken. In July 1979, the Ways and Means Committee agreed to request a modified open rule on H.R. 3712 (the Mortgage Subsidy Bond Act of 1979) from the Rules Committee. The request would have allowed consideration of an amendment providing for a \$100 exclusion (\$200 in the case of a joint return) for interest earned on savings deposits in financial institutions providing home mortgage loans. The Rules Committee adopted a motion to table the rule on October 23, 1979.

2. S. 1846—Senator Talmadge

Partial Exclusion of Interest and Dividends Received by Individuals

Present law

Under present law, the first \$100 of dividends received by an individual from domestic corporations is excludable from gross income. In the case of a husband and wife, each spouse is entitled to a separate exclusion of up to \$100 for dividends received with respect to stock owned by that spouse.

No exclusion from gross income is provided under present law for interest received by an individual from banks, savings and loan associations, or credit unions.

Issues

The first issue is whether an exclusion should be provided for interest received by an individual on certain savings deposits and accounts.

The second issue is whether the existing dividends received exclusion (or an expanded exclusion also covering interest received) should be increased.

Explanation of the bill

The bill would extend the exclusion from gross income to interest received by an individual on certain savings deposits or withdrawable savings accounts. In addition, the limit on the aggregate amount of interest and dividends excludable would be increased to \$250. In the case of a joint return, the limit would be \$500.

Interest eligible for the exclusion would be amounts received on a savings deposit or withdrawable savings account with a commercial or mutual savings bank, a savings and loan association, building and loan association or similar association, and a credit union. However, interest or dividends on such deposits would be eligible for the exclusion only if the deposits or accounts of a bank, association, or credit union, are insured under Federal or State law.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1979.

Revenue effect

This bill would reduce budget receipts by \$430 million in fiscal 1980, by \$3,112 in fiscal 1981, by \$3,280 in fiscal 1982, by \$3,455 in fiscal 1983, and by \$3,379 in fiscal 1984.

Prior Congressional action

In 1974, the Ways and Means Committee reported a bill (H.R. 16994) which provided an exclusion for interest on savings accounts of \$500 for an individual (\$1,000 in the case of a joint return). No floor action was taken. In July 1979, the Ways and Means Committee agreed to request a modified open rule on H.R. 3712 (the Mortgage Subsidy Bond Act of 1979) from the Rules Committee. The request would have allowed consideration of an amendment providing for a \$100 exclusion (\$200 in the case of a joint return) for interest earned on savings deposits in financial institutions providing home mortgage loans. The Rules Committee adopted a motion to table the rule on October 23, 1979.

3. S. 541—Senators Baker and Sasser

Election of Estate Tax Alternate Valuation

Present law

Under present law, the executor of a decedent's estate may value the property in the gross estate as of the date of the decedent's death or the "alternate valuation date," generally six months after the date of the decedent's death (Code sec. 2032). Alternate valuation provides estate tax relief when property in a decedent's estate declines in value shortly after the decedent's death. Alternate valuation must be elected by the executor on an estate tax return filed within nine months of the date of death or any period of extension granted by the Internal Revenue Service (Code sec. 2032(c)).¹

Under Code section 6081, the Internal Revenue Service may grant an extension of time to file an estate tax return. Except in the case of taxpayers who are abroad, the Internal Revenue Service has no discretionary authority to grant an extension exceeding six months.

Issue

The issue is whether an executor should be permitted to elect alternate valuation on an estate tax return that is not timely filed.

Explanation of the bill

The bill would permit the election of alternate valuation on a timely filed estate tax return or the first late return filed. In the case of a

¹ An executor may elect alternate valuation by checking a box on the second page of Form 706, United States Estate Tax Return. An executor's failure to check the appropriate box on a timely filed Form 706 may not prevent the use of alternate valuation where the entries on the form are otherwise consistent with an election of alternate valuation (Rev. Rul. 61-128, 1961-2 C. B. 150).

timely filed return, an executor would not be permitted to change the election after the due date for the return has passed. In the case of a late return, the election could not be changed after the first return has been filed.

Effective date

The provisions of the bill would apply to estates of decedents dying after December 31, 1977.²

The bill includes a transitional rule applicable to estates of decedents dying before January 1, 1978. The transitional rule would permit an effective election of alternate valuation to be made within 90 days after the enactment of the bill, if an election of alternate valuation had been indicated in the first estate tax return filed. If an election is made under the transitional rule, an assessment of a deficiency in tax may be made within 90 days of the election although such assessment is otherwise barred. The transitional rule would benefit the estate of the late Sylvia Buring of Tennessee.

Revenue effect

This bill would have a negligible effect upon budget receipts.

4. S. 555—Senators Morgan, Baker, Sasser, Percy, Inouye, Schmitt, Mathias, Riegle, McGovern, Ford, Cohen, Pell, Helms, Pressler, Durkin, Cochran, Levin, and Stewart

The Independent Local Newspaper Act of 1979

Present law

With respect to a trust established for the purpose of paying estate taxes attributable to an interest in a business (including an independent local newspaper), no provision is presently made under the Code for (1) according tax-exempt status to such a trust, (2) allowing income tax deductions for payments to the trust, or (3) excluding the corpus of the trust from estate taxes.

The Code provides extended payment provisions with respect to the estate tax attributable to interests in closely held businesses (Code secs. 6166 and 6166A).¹

In addition, provision is made for capital gain treatment of certain

² The committee may wish to change the effective date to reflect the passage of time since this legislation was first introduced as S. 3381 in the 95th Congress.

¹ Section 6166 provides a 15-year period for the payment of the estate tax attributable to the decedent's interests in a closely held business (including a farm). Under this provision, the executor can elect to defer principal payments for up to 5 years from the due date of the estate tax return. Thereafter, pursuant to the executor's initial election, the principal amount of the estate tax liability may be paid in from 2 to 10 annual installments. In order to qualify for this deferral and installment payment treatment, the value of the closely held business (or businesses) in the decedent's estate must exceed 65 percent of the value of the gross estate reduced by allowable expenses, indebtedness, and losses.

Section 6166A provides a 10-year extended payment of estate tax attributable to a closely held business where a lesser proportion of the estate is represented by its value. Under this 10-year extension, the value of the business must be in excess of either 35 percent of the value of the gross estate or 50 percent of the taxable estate.

redemptions of closely held business stock where the redemption is for the purpose of paying estate taxes (Code sec. 303).²

Issues

The main issues are (1) whether an independent local newspaper should be permitted to establish a tax-exempt trust to pay estate taxes attributable to the value of an owner's interest in the newspaper, (2) whether the funds contributed to the trust (within prescribed limits) should be deductible by the newspaper and excludable from income by the owner for income tax purposes, (3) whether the value of the trust assets should be excludable from the owner's taxable estate, and (4) whether a 15-year period should be provided for the payment of any estate tax attributable to the value of an interest in the newspaper to the extent the tax was not paid by the trust.

Explanation of the bill

Under the bill, an independent local newspaper could establish a tax-exempt trust to receive payments to pay the estate tax liability of an owner of the newspaper. The newspaper would be allowed an income tax deduction in an amount not to exceed 50 percent of its taxable income for amounts paid to the trust. The trust assets would be required to be invested solely in obligations of the United States. The assets of the trust could be used only to pay the Federal estate taxes of the owner of the newspaper.

The trust would be limited to holding amounts necessary to pay the potential Federal estate tax liability of the newspaper owner. In determining this limitation, the potential estate tax liability of a living individual would be considered to be 70 percent, (i.e., the maximum estate tax rate) of the value of his interest in the business. Under the bill, any interest of a decedent in the trust would generally not be included in the decedent's gross estate.

If the owners of a newspaper which has established a trust for their benefit dispose of their interests in the newspaper, the amounts in the trust must be distributed and included in the owners' income and the deductions previously allowed the newspaper would be recaptured. In addition, if the newspaper is disposed of by an heir within 15 years after the death of the owner, an additional estate tax would be imposed. This tax is phased out after the tenth year following the owner's death.

An "independent local newspaper" is defined as a newspaper publication which is not a member of a chain of newspapers if it has all of its publishing offices in a single city, community, or metropolitan area, or, as of January 1, 1979, within one State. A "chain of newspaper publications" is defined as two or more newspaper publications under common control on January 1, 1979, and which are not published in a single city, community, or metropolitan area.

Under the bill, payment of any estate tax attributable to the value of an independent local newspaper not paid by a trust established under

²To qualify for this treatment, the value of the stock redeemed, plus the value of the other stock of the redeeming corporation includible in the estate, must be more than 50 percent of the "adjusted gross estate." The value of the stock redeemed can be no greater than the sum of all death taxes (and interest) plus funeral and administration expenses allowable as an estate tax deduction.

the provisions of this bill could be extended for a period of up to 15 years. This provision would apply where the estate does not qualify under existing extended payment provisions of present law.

Under this extended payment provision, the executor could elect to defer principal payments for up to 5 years from the due date of the estate tax return. However, interest for the first five years, payable at the rate of 4 percent, would be payable annually. Thereafter, the principal amount of the estate tax liability could be paid in from 2 to 10 annual installments. If the business ceases to qualify as an independent local newspaper, the extension would terminate.

Effective date

The provisions of the bill would apply to estates of decedents dying after January 1, 1979.

Revenue effect

This bill would reduce budget receipts by \$10 million annually.

5. S. 999—Senators Bentsen and Cochran

Interest on Underpayments of Tax

Present law

Under present law, interest is payable where any tax is not paid on or before the last day prescribed for its payment (Code sec. 6601 (a)). The interest runs on the underpayment from the original due date of the tax to the date on which payment is received. The due date of the tax is determined without regard to any extension of time to file a return or to pay a tax.

Generally, the current interest rate on underpayments of tax is 6 percent. The interest rate may be changed every 24 months, and the rate is based upon 90 percent of the adjusted prime rate of interest charged by banks during the month of September preceding the effective date of the change (Code sec. 6621(b)). As of February 1, 1980, the interest rate is scheduled to be increased to 12 percent.¹ A special 4-percent rate applies with respect to certain estate taxes attributable to a closely held business (sec. 6601(j)).

Present law generally does not authorize any waiver of interest due with respect to underpayments of tax.² However, penalties are not applied if the failure to pay is shown to be due to reasonable cause and not due to willful neglect (e.g., sec. 6651(a) (2) and (3)).

Issue

The issue is whether the payment of interest should be excused where an underpayment of tax or a failure to pay tax is due to reasonable cause and not to willful neglect.

Explanation of the bill

The bill would excuse the payment of interest due with respect to an underpayment, or a failure to make payment of tax, if the under-

¹ Rev. Rul. 79-366, issued on October 12, 1979.

² Interest may be waived when an employee of the Internal Revenue Service makes a mathematical error in the preparation of a taxpayer's return (Code sec. 6404(d)).

payment or failure to pay was due to reasonable cause and not to willful neglect.

Effective date

The bill would be effective with respect to taxable years beginning after December 31, 1977.

Revenue effect

This bill would reduce budget receipts by \$40 million in fiscal year 1980, and by \$25 million annually thereafter.

6. S. 1543—Senators Nelson and Bentsen

Dividend Reinvestment Plans

Present law

Under present law, stock dividends received by shareholders generally are nontaxable. However, a stock dividend is treated as a taxable dividend distribution if the shareholder has the option of receiving cash or other property or, in certain cases, if the distribution of stock is disproportionate among shareholders.

In the case of a nontaxable stock dividend, a portion of the shareholder's adjusted basis in the old stock is allocated to the new stock received (sec. 307(a)). For a taxable stock dividend, the shareholder's adjusted basis in the new stock is equal to the fair market value of the stock at the time it is distributed.

For a nontaxable stock dividend, the holding period of the stock received includes the holding period for the old stock with respect to which the distribution was made (sec. 1223(5)). The holding period for stock received in a taxable distribution begins when the stock is distributed.

For purposes of the stock dividend rules, a right to acquire stock generally is treated in the same manner as a stock dividend. However, special basis allocation rules apply to stock rights (sec. 307(b)) and, when a right is exercised, a special holding period rule applies (sec. 1223(b)).

Issue

The issue is whether an exclusion should be provided with respect to "qualified dividend reinvestment plans" under which a shareholder could elect to receive a limited amount of nontaxable common stock dividends instead of receiving cash or other property dividends.

Explanation of the bill

Under the bill, a domestic corporation (other than a regulated investment company) would be allowed to establish a "qualified dividend reinvestment plan" under which any shareholder who chooses to receive a dividend in the form of common stock rather than cash or other property may elect to exclude up to \$1,500 per year (\$3,000 in the case of a joint return) of these stock dividends from income.

Under the bill, qualified stock must be authorized but unissued common stock designated by the corporation to qualify for this tax exclusion. The number of shares to be issued must be determined by refer-

ence to a value not less than 95 percent of the stock's value on the distribution date. Stock will not qualify where the corporation repurchases any of its common stock within one year after the distribution date, unless a business purpose of repurchasing the stock is established.

Stock received as a qualified dividend will have a zero basis, so that when the stock is later sold, the amount of the sales proceeds will be taken into income at that time. Where the stock is sold within one year after distribution, any gain will be treated as short-term capital gain. In addition, where shares of common stock of the distributing corporation are sold by the shareholder any time within one year following receipt of the stock, the sale will be treated as a sale of the qualified dividend stock.

Effective date

The bill would apply to distributions made on or after January 1, 1980.

Revenue effect

It is estimated that this bill will reduce budget receipts by \$240 million in the fiscal year 1980, \$718 million in 1981, \$925 in 1982, \$1,044 in 1983, and \$1,035 million in fiscal year 1984.

Prior Congressional action

During markup of the Tax Reduction Act of 1975, the Ways and Means Committee rejected an amendment to authorize dividend reinvestment plans.

7. S. 1638—Senator Roth

Amortization of Business Startup Costs

Present law

In general

Under present law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not currently deductible since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity.

Expenses or costs incurred in acquiring or creating an asset, *e.g.*, a business, which has a useful life that extends beyond the taxable year normally must be capitalized. These costs ordinarily may be recovered through depreciation or amortization deductions over the useful life of the asset. However, costs which relate to an asset with either an unlimited or indeterminate useful life may be recovered only upon a disposition or cessation of the business.

Certain business organizational expenses incurred in the formation of a corporation or partnership may be treated as deferred expenses and amortized over 60 months (secs. 248 and 709). Expenditures eligible for amortization include only those expenditures which are directly incident to the creation of the corporation or business. Pre-opening or startup expenses, such as employee training expenses, are ineligible for amortization under this provision.

Investigatory expenses

Business investigatory expenses may be of either a general or specific nature. The former are related either to businesses generally, or to a category of business; the latter are related to a particular business. All investigatory expenses are costs incurred in seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business.

Business investigatory expenses generally are nondeductible regardless of the status of the taxpayer by whom they may be incurred. However, taxpayers may be able to deduct a loss for business investigatory expenses incurred in an unsuccessful attempt to acquire a specific business.¹ Nevertheless, business investigatory expenses of a general nature normally are viewed as being either nondeductible personal expenses, or as not being ordinary and necessary trade or business expenses, viz., because no business exists, within the meaning of section 162 of the Code.

Startup costs

Startup or preopening expenses are those costs which are incurred subsequent to a decision to acquire or establish a particular business, and prior to its actual operation. Generally the term "startup costs" refers to expenses which would be deductible currently if they were incurred after the commencement of business operations. These costs may include expenses relating to advertising, employee training, lining-up distributors, suppliers, or potential customers, and professional services in setting up books and records. However, startup expenses also may refer to certain items which are nondeductible and nonamortizable even if they are incurred prior or subsequent to commencement of business operations. These nondeductible and nonamortizable expenses either may be of a purely capital nature, or may be capitalizable simply because they relate to a business with an indeterminate life.

Issue

The issue is whether "startup" expenses paid or incurred by a taxpayer prior to the active operation of a trade or business should be deductible currently or as deferred expenses over a period of not less than 60 months after the commencement of the trade or business as a going concern.

Explanation of the bill

The bill would allow taxpayers an election to amortize, over a period of not less than 60 months, ordinary and necessary startup costs incurred incident to the investigation, formation, and creation of a trade or business entered into by the taxpayers. The amortization election would apply only to ordinary and necessary startup costs which do not create an asset which has a useful life of its own and which are of a character which would allow the taxpayer to amortize them if they were expended incident to the investigation, formation, and creation of a trade or business having a determinable useful life. The election would apply only with respect to expenditures incurred with

¹ See *Harris W. Seed*, 52 T.C. 880 (1969), *acq.*, 1970-2 C.B. xxi; Rev. Rul. 77-254, 1977 2 C.B. 63.

regard to a business actually entered into by the taxpayer, and would not apply if the business had an ascertainable useful life of less than 60 months. If the business is liquidated prior to the end of the 60-month period, any "startup" expenses which had not been amortized could be deducted to the extent allowed under present law.

Effective date

The bill would apply to amounts paid or incurred after December 31, 1979.

Revenue effect

Due to the lack of adequate information on the number of potential businesses formed or investigated and on the amount of expenses incurred in the process covered by the bill, no revenue estimate is available at this time.

8. S. 1703—Senators Chafee, Cochran, Matsunaga, Moynihan, Jepsen, Ribicoff, Boren, Long, Cranston, Mathias, Wallop, Talmadge, Hatfield, and Baucus

Tax Treatment of Employees of Charities Working Abroad

Present law

In general

United States citizens and residents are generally taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1978, U.S. citizens working abroad could exclude up to \$20,000 of earned income a year if they were present in a foreign country for 17 out of 18 months or they were *bona fide* residents of a foreign country for a period which included an entire taxable year (sec. 911). In the case of individuals who had been *bona fide* residents of foreign countries for three years or more, the exclusion was increased to \$25,000 of earned income. In addition, under the law prior to 1978, foreign taxes paid on the excluded income were creditable against the U.S. tax on any foreign income above the \$20,000 (or \$25,000) limit.

The Tax Reform Act of 1976 would generally have reduced the earned income exclusion for individuals working abroad to \$15,000 per year. However, the Act would have retained a \$20,000 exclusion for employees of domestic charitable organizations. (The term "charitable" as used in this explanation includes educational, religious, scientific, literary, etc., purposes for which an exemption is allowed under section 501(c)(3).) In addition, the Act would have made certain modifications in the computation of the exclusion. The Act provided that any individual entitled to the earned income exclusion was not to be allowed a foreign tax credit with respect to foreign taxes allocable to the amounts that were excluded from gross income under the earned income exclusion. Also, the Act provided that any additional income derived by individuals beyond the income eligible for the earned income exclusion was subject to U.S. tax at the higher rate brackets which would apply if the excluded earned income were not so excluded (i.e., the exclusion was "off the bottom").

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. (The basic eligibility requirements for the deduction are generally the same as for the prior earned income exclusion.) However, because the provisions of the 1978 Act were effective on January 1, 1978, and the Act did not become law until November 8, 1978, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under prior law (the exclusion as amended by the Tax Reform Act of 1976) so that the 1978 Act would not have any mandatory retroactive effect. It was anticipated that this election would be of particular interest to employees of domestic charitable organizations, since under the 1976 Act they would continue to be eligible for a \$20,000 exclusion, even though it would be subject to the new computation rules of the 1976 Act.

Excess living cost deduction

The new excess living cost deduction (new sec. 913) provided by the 1978 Act consists of separate elements for the general cost of living, housing, education, and home leave costs. Employees of charitable organizations are allowed these deductions on the same basis as other individuals. The cost-of-living element of the deduction is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a Federal employee at grade level GS-14 step 1, regardless of the taxpayer's actual income. The housing element is the excess of the taxpayer's reasonable housing expenses over his base housing amount (generally one-sixth of his net income). The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable cost of coach fare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

Hardship area exclusion

In addition, taxpayers living and working in certain hardship areas are allowed a special \$5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. For this purpose, hardship areas are generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees is 15 percent or more of their base pay.

As an exception to these new rules, the Act permits employees who reside in camps in hardship areas to elect to claim a \$20,000 earned income exclusion (under sec. 911) in lieu of the new excess living cost and hardship area deductions. No foreign tax credit would be allowed for foreign taxes attributable to the excluded amount. Lodging is not a "camp" unless it is substandard lodging which is (i) provided by or on behalf of the employer for the convenience of the employer because the place at which the individual renders services is in a remote area

where satisfactory housing is not available on the open market; (ii) located, as near as practicable, in the vicinity of the place at which the individual renders services; and (iii) furnished in a common area (or enclave) which is not available to the public and which normally accommodates 10 or more employees. The term "hardship area" has the same meaning for purposes of this provision as for the deduction for excess foreign living costs (sec. 913).

Charitable services

In many instances, an exclusion of earned income is of little consequence to Americans working abroad because the credit allowed for foreign income taxes imposed on the earnings may entirely or substantially offset the U.S. tax due on the income. However, certain charitable employees working abroad are exempt from foreign tax. This is the case, for example, for certain educators under a number of tax treaties between the United States and foreign countries.

Issue

The issue is whether employees of charitable organizations should be permitted to elect the same treatment under the 1978 Act as employees who reside in camps located in hardship areas, i.e., a \$20,000 annual exclusion in lieu of the excess foreign living cost deductions.

Explanation of the bill

The bill would allow individuals meeting the foreign residence or presence tests who perform "qualified charitable services" to elect, in lieu of the deduction for excess foreign living costs, an exclusion of \$20,000 from gross income on the same basis as employees residing in camps in hardship areas. "Qualified charitable services" are defined to mean services performed by an employee for an employer which meets the requirements of section 501(c)(3).

In the event that an individual resides in a camp in a hardship area for part of the taxable year and performs qualified charitable services for another part of the year, the \$20,000 limitation applicable to the amount excludable as a camp employee would be reduced by the amount excluded as a charitable employee.

The treatment afforded by the bill is similar to the treatment afforded to charitable employees under the 1976 Act in that in each case the employee is entitled to exclude up to \$20,000 of foreign earned income. It differs from the 1976 Act in that (i) it is available to employees of any organization qualifying for exemption under section 501(c)(3), whether the organization is foreign or domestic, (ii) the exclusion is "off the top," rather than "off the bottom," and (iii) the employee may elect the deduction for excess foreign living costs, if that is more favorable.

Effective date

The bill would apply to taxable years beginning after December 31, 1978.

Revenue effect

This bill would reduce budget receipts by \$39 million in fiscal 1980, by \$28 million in fiscal 1981, by \$30 million in fiscal 1982, by \$33 million in fiscal 1983, and by \$36 million in fiscal 1984.

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