[COMMITTEE PRINT]

DESCRIPTION OF H.R. 7320; MISCELLANEOUS REVISIONS RELATING TO VARIOUS TIMING REQUIREMENTS UNDER THE INTERNAL REVENUE CODE

PREPARED FOR THE USE OF THE

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I. INTRODUCTION

This pamphlet describes a number of miscellaneous revisions to the tax laws contained in H.R. 7320. The provisions contained in the bill have been developed from a list of legislative recommendations submitted by the American Bar Association, the American Institute of Certified Public Accountants and various other groups including State and local bar and accounting associations. In general, these provisions relate to various timing requirements of the Federal tax laws.

The staff of the Joint Committee on Taxation prepared the descriptions in this pamphlet of each item under the bill in a manner similar to the descriptions prepared in connection with hearings on miscellaneous bills in the 94th Congress. The description indicates the present law treatment, the issue involved, and an explanation of the provision.

II. DESCRIPTION OF PROVISIONS

A. Period for Payment to Qualify for Deductibility of Certain Expenses Paid to Related Taxpayers (sec. 2 of the bill and sec. 267(a) of the Code)

Present law

Under present law (sec. 267(a)), an accrual basis taxpayer is denied a deduction for certain accrued expenses or interest owed to certain related persons who are on the cash basis. The disallowed expenses are those which are not paid to the related person, or are not constructively received by him, within the taxable year in which the expenses are accruable, or within 2½ months thereafter. This provision prevents an accrual-basis taxpayer from claiming a deduction for an accrued expense which the related cash-basis payee is not required to take into income until some subsequent time, if at all.

Because an accrued expense is deductible by a taxpayer under the accrual method of accounting only in the taxable year in which it accrues, a deduction disallowed (under section 267(a)) is permanently lost. It cannot be deducted at some subsequent time when payment is made.

In determining whether certain acts are performed timely, present law (sec. 7503) generally provides that when the last day for performing any act falls on a Saturday, Sunday, or a legal holiday, the act is timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or legal holiday. However, the Internal Revenue Service has ruled that section 7503 covers only procedural steps in connection with the determination, collection, or refund of taxes; section 7503 does not extend the 2½-month period (under section 267(a)) during which accrued expenses owed to a related person must be paid by the taxpayer, or constructively received by the related person. (Rev. Rul. 72-541, 72-2 C.B. 645)

Issue

The issue is whether the required payment period under section 267 (a) should be extended if the payment period ends on Saturday, Sunday, or legal holiday.

Explanation of provision

This amendment would extend the timely performance rule of section 7503 to section 267 (a). As a result, the 2½-month period (under section 267(a)) during which payments must be made (or constructively received) in order to be deductible would be extended if the period ends on a Saturday, Sunday, or legal holiday.

B. Increase in Basis for Amount of Gain Recognized to the Distributing Corporation (sec. 3 of the bill and secs. 301(b)(1)(B) and 301(d)(2) of the Code)

Present law

Under present law (sec. 301(b)(1)(B)), if property is distributed by a domestic corporation to another domestic corporate shareholder, the amount of the distribution treated as a dividend to the distributee corporation is an amount equal to the lesser of (1) the fair market value of the property received, or (2) the adjusted basis of the property to the distributing corporation, plus any income or gain recognized by the distributing corporation upon the distribution pursuant to certain designated code sections.[1] These designated code sections provide for recognition of gain upon the disposition of certain types of property, such as LIFO inventory, properties subject to indebtedness in excess of basis, appreciated property used to redeem stock, real and personal property on which depreciation was claimed, farmland, and interests in oil or gas properties. Corresponding rules apply in determining the reduction in the earnings and profits of the distributing corporation (sec. 312(c)).

The same rule is provided with respect to the computation of the basis of the property received by a domestic distributee-corporation (sec. 301(d)(2)).

These provisions prevent double taxation at the corporate level of the same gain (once at the distributor-corporation level and again at the distributee-corporation level) by allowing a step-up in basis to the extent gain is recognized by the distributor-corporation. (The corporate dividends received deduction also operates to mitigate against double taxation at the corporate level (sec. 243)). If a step-up in basis were not provided in these instances, double taxation of a portion of the gain would occur upon the subsequent sale or disposition of the property by the distributee-corporation.

However, in at least one instance and possibly others, reference is not made to a code section which would require the recognition of gain by a corporation upon the distribution of property to another corporation. Thus, while gain would be recognizable upon a corporation's distribution of an installment obligation to the distributee corporation (under section 453(d)), no increase in the amount of distribution and basis would result because the installment disposition provision is not specifically designated under either the dividend inclusion rule or the basis rule for property distributed to a corporate shareholder. Moreover, there are other corporate distribution situations with respect to which certain case law would require recognition of gain.

Thus, the dividend inclusion rule and corporate-distributee basis rule are not inclusive of all situations in which gain is recognized. As a result, the potential for some double taxation exists for those

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[1] Sections 311(b), (c), and (d), 341(f), 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), and 1254(a).

recognition situations which are not specifically covered by these provisions (sections 301(b)(1)(B) and 301(d)(2)).

Issue

The issue is whether a general provision should be provided to allow an adjustment to basis for a distributee-corporation where gain is recognized upon the distribution of property by the distributor-corporation.

Explanation of provision

The bill deletes the specific reference to the provisions of the code requiring recognition of gain upon certain distributions, and substitutes a general provision that the amount of the distribution and the basis of the property to the distributee will be increased by all gain recognized upon the distribution.

C. 60-Day Extension of 12-Month Period for Nonrecognition of Gain in Connection With Certain Liquidations Where There is an Involuntary Conversion (sec. 4 of the bill and sec. 337 of the Code)

Present law

Under present law, a corporation, which adopts a plan of complete liquidation and within 12 months thereafter distributes all of of its assets to its shareholders, does not recognize gain or loss on the sale of property during the 12-month period. Prior to the enactment of this provision of the code (sec. 337), a sale of property by a corporation which subsequently liquidated generally resulted in two taxes—one tax on the corporation on the gain realized on the sale, and a second tax on the shareholders on the gain realized by them when they received the proceeds from the corporation in complete liquidation of their stock. Prior to enactment of section 337, the tax on the sale could generally be avoided only by a distribution of assets to the shareholders in a taxable liquidation followed by a sale under which gain was not realized because the bases of the assets were equal to the sales price. The Congress changed the law in 1954 because these differences accorded undue weight to the formalities of the transaction and they, therefore, represent merely a trap for the unwary. The Congress opted to eliminate the tax at the corporate level. Section 337 generally eliminated the distinction between (1) a distribution of assets followed by a sale (one tax) and (2) a sale followed by a distribution of sale proceeds to shareholders (two taxes). (In certain other cases the incidence of two taxes can be avoided or minimized under a so-called "one-month" liquidation where the liquidating corporation has little earnings and profits or does not distribute a significant amount of cash.)

The three major requirements of current law are: (1) that a plan of complete liquidation be adopted on or before the date of the sale or exchange, (2) that the sale or exchange occur within the 12-month period beginning on the date of adoption of the plan, and (3) that all proceeds be distributed in complete liquidation within the 12-month period.

Under present law, an involuntary conversion of property which results from a fire or condemnation proceeding is a "sale or exchange" eligible for non-recognition of gain or loss under this provision. In the case of a fire, the Supreme Court held that the sale or exchange occurs at the time of the fire even if the insurance proceeds are not determinable at that time, *Central Tablet Manufacturing Co.* v. *U.S.*, 417 U.S 673 (1974). Similarly, the transfer of ownership to the State in the case of condemnation constitutes a "sale or exchange," even if the owner did not have notice of the action. In some States, filing of documents in court is sufficient to transfer ownership of the condemned property, and subsequent litigation as to the amount of the condemnation award does not change the date of "sale" for purposes of the 12-month liquidation provision.

In the case of destruction of property by fire or other casualty, it is difficult if not impossible to take action to adopt a plan to liquidate on the date the fire or other casualty occurs.[2] If a corporation decides after an involuntary conversion to liquidate, any gain arising from the involuntary conversion is subject to double taxation if the corporation did not adopt a plan on the date of the involuntary conversion or did not happen to have a plan in existence before the date of the conversion. Similar considerations arise in connection with condemnations. To the extent that the taxpayer has little knowledge of an impending condemnation, the corporation may be unable to adopt a plan of liquidation on or before the date of the condemnation.

Issue

The issue is whether a special nonrecognition rule should be provided in the case of an involuntary conversion.

Explanation of provision

The bill extends nonrecognition treatment to gain or loss resulting from the destruction, theft, seizure, requisition, or condemnation of property, or from the sale or exchange of property under the threat or imminence of requisition or condemnation, if a plan of liquidation is adopted within 60 days after the date the involuntary conversion occurs, and the liquidation otherwise qualifies under the 12-month liquidation provision (sec. 337). However, this additional nonrecognition provision will apply only if the liquidating corporaton so elects.

D. Extension of Period for Making Subchapter S Elections (sec. 5 of the bill and sec. 1372(c) of the Code)

Present law

Subchapter S was enacted in 1958 in order to minimize the effect of Federal income taxes on the form in which a business is conducted by permitting incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and shareholder levels. The subchapter S rules allow corporations engaged in active trades or businesses to elect to be treated for income tax

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[2] Under the statute, the nonrecognition provision applies to sales or exchanges taking place on the date the plan is adopted.

purposes in a manner similar to that accorded partnerships. Where an eligible corporation elects under the subchapter S provisions, the income or loss (except for certain capital gain) is not taxed to the corporation, but each shareholder reports a share of the corporation's income or loss each year in proportion to his share of the corporation's total stock. Once made, the election continues in effect for the taxable year and subsequent years until it is terminated.

Present law requires that in order for a subchapter S election to be effective for a taxable year, it must be filed during a limited 2-month period which begins 1 month before the start of the taxable year. (For example, if a calendar year corporation wishes to elect subchapter S effective for its 1978 tax year, the election must be filed during December of 1977 or January of 1978.) An election is not valid for either the intended year or any future year if it is not filed within this period. Extensions of time for filing the election are not granted. Rev. Rul. 60–183, 1961–1 C.B. 625. If an election is found to be untimely upon audit several years later, the corporation is taxed as a regular corporation for all the intervening years, *Opine Lumber Co., Inc.*, 64 T.C. 700 (1975).

In effect, the period of time during which an election can be made by a newly-formed corporation for its first taxable year is only one month since a new corporation cannot make the election until it is in existence under State law, which generally occurs at the same time as the beginning of its first taxable year. *J. William Frentz*, 44 T.C. 485 (1965), aff'd, 375 F. 2d 662 (6th Cir. 1967). In other situations it has been difficult to determine when the 1-month period begins for a new corporation to make the election begins because of several alternative rules used to determine when its first taxable year begins.

Issue

The issue is whether the period for making the subchapter S election should be expanded.

Explanation of provision

Under the bill, the period of time to make the subchapter S election is expanded to include the entire preceding taxable year for small business corporations. In addition, a newly formed corporation may make the election during the first 75 days of its first taxable year, rather than the 1-month period provided under present law.

E. Time for Filing Income Tax Returns in the Case of Organizations Exempt from Taxation Under Section 501(a) (sec. 6 of the bill and sec. 6072 of the Code)

Present law

Under present law, income tax returns on the unrelated business taxable income of calendar year corporations exempt from tax under section 501(a) of the code, must be filed on or before the 15th day of March following the close of the calendar year, and such returns made on the basis of a fiscal year must be filed on or before the 15th day of the third month following the close of the fiscal year. Similarly, trusts exempt from tax under section 501(a) must file income

tax returns on their unrelated business taxable income on or before the 15th day of April in the case of returns made on the basis of the calendar year, or, in the case of returns made on the basis of the fiscal year, on or before the 15th day of the fourth month following the close of the fiscal year. However, annual information returns of these exempt organizations (other than certain religious or apostolic organizations) must be filed on or before the 15th day of the fifth calendar month following the close of the taxable year. Thus, the due date for an exempt organization's information return is different from the due date for the organization's income tax return.

Issue

The issue is whether the due dates for filing the unrelated business income tax return and the annual information return for an exempt organization should be conformed.

Explanation of provision

The provision generally conforms the due date for an exempt organization to file a return of unrelated business income to the due date for filing an annual information return. Under this provision, an organization exempt from tax under section 501(a), other than an employees' trust described in section 401(a), must file its income tax return on or before the 15th day of the fifth month following the close of the taxable year. For a calendar year organization, the return would have to be filed by May 15.

F. Period for Determining Whether the Taxpayer is a Farmer or a Fisherman for Purposes of the Estimated Tax (sec. 7 of the bill and sec. 6073(b) of the Code)

Present law

Under present law, an individual generally is required to file quarterly declarations of estimated income tax if his tax liability not covered by withholding can be expected to be $100 or more and he will have a certain amount of gross income or nonsalary income (secs. 6015 and 6073). An addition to tax generally is imposed on an underpayment of estimated tax. The rate of this addition to tax is equal to interest rate on underpayments of tax and is based on the amount of underpayment for the time between the due date of the estimated tax payment and the due date of the tax return unless one of several exceptions apply (sec. 6654).

However, special provisions apply to farmers and fishermen. Under these provisions, an individual may postpone the filing of an estimated tax return (and the payment of estimated taxes) for a taxable year until January 15th of the succeeding taxable year if his estimated gross income from farming or fishing for the taxable year is at least two-thirds of the total estimated gross income from all sources for the taxable year.[3] Thus, under present law, if an individual relies on the

[3] Also, an individual who qualifies for deferral of estimated tax payments under this rule is not required to make a declaration of estimated tax or payment of estimated tax on January 15th, if he files a tax return on or before March 1 of the following year and pays the full amount of tax at that time (sec. 6015(f)).

special rules for farmers and fishermen in the belief that at least two-thirds of his current gross income will be from farming or fishing and it later develops that this is not the case (for instance, because of a crop failure), the taxpayer may not be able to avoid the addition to tax for underpayment of estimated tax.

Issue

The issue is whether the special rules for filing estimated tax returns in the case of farmers and fishermen should be available if the requirements are satisfied on the basis of gross income for the preceding taxable year.

Explanation of provision

The bill would extend the exception from quarterly declarations of estimated tax so that the special rule for farmers and fishermen also applies when at least two-thirds of the gross income shown on an individual's tax return for the preceding taxable year was gross income from farming or fishing.

G. Period of Limitations for Credit or Refund With Respect to Certain Carrybacks of Losses and Credits (sec. 8 of the bill and sec. 6511 of the Code)

Present law

Under present law (sec. 6511(d)(2)(A)), a claim for refund or credit attributable to a carryback of a net operating loss or capital loss must be filed within 3 years of the due date of the corporate or individual tax return for the taxable year of the loss, without regard to any extensions of time which may be granted for filing the return (including automatic extensions) unless a written extension of the period of limitations on assessment was obtained. Similar rules are applied with respect to the carryback of the investment credit, work incentive credit and the new jobs credit. A claim for refund or credit other than those arising from a carryback may be filed within 3 years after the return is filed without regard to whether the return was filed after the statutory due date.

Since, under present law, a claim for refund attributable to a carryback of a net operating loss, capital loss or the previously mentioned credits must be filed within 3 years from the return due date without regard to an extension of time, it is possible for a carryback claim to be barred by the statute of limitations at a time that deficiencies attributable to the carryback may still be assessed.

Issue

The issue is whether the limitation period for filing claims with respect to loss carrybacks, where the taxpayer has filed a timely return for the loss year, should be the same as the limitation period for asserting deficiencies attributable to the carryback.

Explanation of provision

The provision amends section 6511(d)(2)(A) to provide that a claim for credit or refund relating to an overpayment attributable to a net operating loss carryback or a capital loss carryback may be filed

within 3 years after the time for filing the return, including extensions, for the loss year. A similar rule applies to the carrybacks of the investment credit, the work incentive program credit and the new jobs credit.

H. Stay of Collection of Penalty Under Section 6672 Where Bond is Filed (sec. 9 of the bill and sec. 6672 of the Code)

Present law

Present law (sec. 6672) imposes a civil penalty upon any person who willfully fails to collect or pay over any tax imposed by the Internal Revenue Code. The penalty is equal to the amount of tax which has not been collected or paid over. This penalty, called the 100-percent penalty for failure to pay over, applies not with regard to the personal tax liability of the person potentially subject to the penalty but rather to tax for which another person is primarily liable, e.g., an employer's liability for payroll withholding.

In the case of Tax Court litigation, a taxpayer need not pay a deficiency asserted by the Government until the final adjudication of his case, and the Government may not levy on his property or begin any other collection procedure in the meantime.[4] However, the 100-percent penalty is not subject to Tax Court jurisdiction. Instead, the person subject to the penalty generally is restricted to filing with the Internal Revenue Service a claim for refund for the penalty after at has been paid or collected. If the Service denies the claim (or fails to respond within 6 months), a suit for refund can be filed in either a U.S. district court or the Court of Claims.[5]

Thus, under present law, there is generally no procedure whereby the person subject to penalty may stay enforcement of the penalty pending a judicial determination. The Internal Revenue Service may assess the penalty immediately after it is determined and, 10 days after notice and demand for payment is made, enforce the assessment by various collection procedures, including a seizure of the property of the person assessed with the penalty. These collection proceedings and the imposition of a lien against that person's property may seriously endanger the business or credit of the person against whom the penalty was assessed.

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[4] In the case of jeopardy assessments, immediate assessment and collection may be made but a new provision was added under the Tax Reform Act of 1976 to obtain expedited administrative and judicial review of jeopardy assessments (secs. 6331, 6861, 6862, and 7429).

[5] The 100-percent penalty is frequently imposed on account of a failure to pay over withholding employment taxes. These are separate taxes as to each individual, and the position of the IRS as to whether individuals are employees or independent contractors can be challenged by paying the amount of the taxes for only one of those individuals and suing for a refund of that amount. In addition, the plaintiff could demand abatement of the penalty attributable to the withholding taxes of the other individuals whose status is questioned. However, even in this situation, the Government could file liens and levy on the plaintiff's property for the amount of the penalty that is not yet paid.

Issue

The issue is whether the person against whom assessment is made should be able to post a bond and thereby stay enforcement of collection of the 100-percent penalty under section 6672.

Explanation of provision

This provision would stay collection proceedings against a person assessed with the penalty if he posts a bond equal to one and one-half times the amount of the unpaid penalty. In addition, the person posting the bond must pay an amount sufficient to initiate refund litigation (in the case of a penalty resulting from nonpayment of employment taxes, this would be the withholding taxes attributable to one individual), file a refund claim, and begin court proceedings within 30 days after a denial of the refund claim.

III. REVENUE EFFECT

It is estimated that the provisions contained in the bill, H.R. 7320, will not have any significant revenue effect.