GENERAL EXPLANATION

OF THE

TAX REFORM ACT OF 1976

(H.R. 10612, 94TH CONGRESS, PUBLIC LAW 94–455)

PREPARED BY THE

STAFF OF THE

JOINT COMMITTEE ON TAXATION

DECEMBER 29, 1976

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CONGRESS OF THE UNITED STATES

(94th Cong., 2d sess.)

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LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, D.C., December 29, 1976.

Hon. RUSSELL B. LONG, *Chairman*,
Hon. AL ULLMAN, *Vice Chairman, Joint Committee on Taxation, U.S. Congress, Washington, D.C.*

DEAR MESSRS. CHAIRMEN: While committee reports explain the position of the House Committee on Ways and Means, or the position of the Senate Committee on Finance, they do not in all cases explain the tax legislation as finally passed by the Congress. This becames particularly important in the case of major legislation where there are many changes between the bill as passed by the House, or as passed by the Senate, and the bill which finally becomes public law. The Tax Reform Act of 1976, because of its comprehensive scope and because of the many changes which were made in this legislation, both by the Senate and subsequently by the conferees, is an illustration of where the differences were especially significant.

This document represents the effort of the staff of the Joint Committee on Taxation to provide an explanation of the Tax Reform Act of 1976 as finally enacted and is comparable to a number of similar documents prepared by the staff on other revenue acts in recent years. For the most part, where provisions which were unchanged in conference were described in either the House or Senate report, that explanation is carried over in this document. No attempt is made here to carry the explanation further than is customary in the case of committtee reports and therefore it does not deal with issues which are customarily explained in regulations or rulings.

The first major part of the document contains a summary of and the reasons previously given for the various provisions. The second part contains the revenue estimates on the legislation as finally enacted and the third part is a general explanation of the provisions appearing in the order in which they appear in the public law.

This material has been prepared by the staff of the Joint Committee on Taxation after the Tax Reform Act of 1976 was passed. It has not been reviewed by the tax committees and therefore only reflects the staff's view as to the intent of Congress. It is hoped that this document will be useful in gaining a better understanding of the Tax Reform Act of 1976.

Sincerely yours,

LAURENCE N. WOODWORTH,
Chief of Staff.

LEGISLATIVE HISTORY OF THE ACT

The Tax Reform Act of 1976 was the result of over two years of legislative deliberations largely during the 94th Congress, although some of the provisions were originally considered by the House Ways and Means Committee during the 93rd Congress.[1] Consideration of the Act in the 94th Congress proceeded on the following schedule:

June 23 through June 25, 1975: Panel Discussions before the House Committee on Ways and Means.

July 8 through July 31, 1975: Hearings before the House Committee on Ways and Means.

November 12, 1975: Bill (H.R. 10612) reported by the House Committee on Ways and Means (House Report 94–658).

December 3 and 4, 1975: Bill considered and passed by the House of Representatives.

March 17 through April 13, 1976; July 20 through 22, 1976: Hearings before the Senate Committee on Finance.

June 10, 1976: Bill reported by the Senate Committee on Finance (Senate Report 94–938): Supplemental report filed by Senate Committee on Finance on July 20, 1976 (Senate Report 94–938, Part 2).

June 16–18, 21–25, 28–30, July 1–2, 20–23, 26–30, and August 3–6, 1976: Bill considered and passed by the Senate.

September 13, 1976: Committee on Conference submitted Conference Report (House Report 94–1515; Senate Report 94–1236).

September 16, 1976: Conference report (and House Concurrent Resolution 751) approved by the House and Senate.

October 4, 1976: Tax Reform Act of 1976 (Public Law 94–455) signed by the President.

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[1] The Ways and Means Committee did not report a tax reform bill in the 93rd Congress but did hold extensive discussions (February 5–28, 1973) and hearings (March 5 through May 1, 1973) on the subject. The Ways and Means Committee also held legislative markup sessions on tax reform late in the 2nd session (1974), but had only made tentative decisions prior to the end of the 93rd Congress. In addition, H.R. 17488, The Energy Tax and Individual Relief Act of 1974, reported by that committee on November 26, 1974 (House Report 93–1502), included provisions relating to real estate investment trusts and the taxation of foreign income, much of which was later included in the Tax Reform Act of 1976.

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I. SUMMARY AND REASONS FOR THE ACT

The Tax Reform Act of 1976 will serve six major purposes. First, it will improve the equity of the tax system at all income levels without impairing economic efficiency and growth. Second, the Act effects important simplifications of the tax system by modifying certain deductions and credits affecting individuals, by increasing the standard deduction to encourage taxpayers to switch from itemizing their deductions to using the standard deduction, and by redrafting complex provisions of the tax law and deleting obsolete and little used provisions. Third, the Act extends the fiscal stimulus provided by the Tax Reduction Act of 1975 and extended by the Revenue Adjustment Act of 1975, and makes permanent part of these tax cuts for individuals. Fourth, the Act encourages capital formation by extending the increased investment credit for four years, by modifying the application of the credit, by extending and revising the incentive for investing in employee stock ownership plans, and by liberalizing the net operating loss carryover. Fifth, it improves the administration of the tax laws by making it more efficient and strengthening taxpayers' rights. Sixth, the Act makes a major revision in the estate and gift taxes. It reduces the estate and gift tax for small- and medium-sized estates and at the same time eliminates tax avoidance possibilities.

In addition, the Act makes certain changes in the operation of the U.S. International Trade Commission as well as the withholding of preferential trade treatment for countries who aid or abet international terrorists.

A. TAX REVISION

While no one contends that our income tax system does not need improving, it is still widely acknowledged to be the best in the world. The difficulty faced in improving the system is that the American people want different things from their tax system. On the one hand, they want every individual and corporation to pay a fair share of the overall income tax burden. In a system that depends heavily on voluntary compliance with the tax laws, as ours does, tax equity is especially important. However, at the same time, Americans do not want the income tax system to interfere with economic efficiency and growth. This implies that tax changes to promote equity should not retard either the current recovery from what has been the worst recession since the 1930's or impede the long-run growth of the economy. The tax revisions in the Act represent a careful balance between these sometimes conflicting objectives.

The Act contains many tax revisions, described in more detail below, designed to eliminate tax abuses and make the tax system more equitable.

Tax shelter provisions

Congress believed that changes were needed to end the excessive tax deferrals provided by tax shelters, as well as the opportunity they provide to, in effect, convert ordinary income into capital gains. Too many investments have been motivated by excessive concern with the tax benefits associated with them, not their economic merits. In some cases, the manner in which the tax shelters were contrived was questionable even under prior law. In others, individuals were combining provisions of the law, or leveraging them through nonrecourse borrowings, in a way which multiplied severalfold any possible advantages intended by Congress. Such activities reduce citizens' respect for the income tax and represent an inefficient allocation of resources. The Act contains a number of provisions designed to curb these abuses without interfering with economically worthwhile investments.

The Act expands the use of the so-called "recapture" rules to prevent conversion of ordinary income into capital gains in the case of real estate, oil and gas drilling and sports franchises. For oil and gas drilling, farm operations, equipment leasing, and film purchases and production, losses from accelerated deductions are limited to the amount for which the individual is "at risk." This is designed to prevent leveraging of tax shelter benefits through the use of nonrecourse loans. There is also an "at risk" rule for limited partnerships in areas not specifically dealt with by the Act, which should discourage development of new leveraged tax shelters. In addition, in the case of farm syndicates (or passive farm partnerships) and motion picture production companies (and companies producing books, records, etc.), certain costs are required to be capitalized and written off over the productive period of the related assets, or the writeoff is delayed until the items involved are used. For real estate, the Act also requires capitalization of interest and taxes during the construction period.

The provisions relating to various deductions and exclusions in the case of partnerships are tightened so that the deductions or exclusions cannot be allocated among the various partners according to whomever can maximize the tax benefits unless such allocation has substantial economic effect. Also, limits are placed on the amount of "bonus" first-year depreciation deductions of the partners. The Act requires prepaid interest to be deducted over the period to which it relates and requires use of accrual accounting by many farm corporations. Also, it tightens the existing limit on deductions of excess investment interest.

Minimum and maximum taxes

Congress believed that high-income people and corporations should not be able completely to escape liability for income tax. Preventing this is a major feature of the Act. It greatly reduces the incidence of tax avoidance by high-income people through two related provisions—a stiffer minimum tax on tax-preferred income and a revision in the maximum tax designed to discourage use of tax preferences.

Minimum tax

The prior minimum tax for individuals was inadequate. In 1974 it raised only $130 million, down from $182 million in 1973, which is only a small fraction of total tax-preferred income. Also, the minimum tax for individuals was largely a tax on one preference—the excluded half of capital gains. The Act amends the minimum tax both to increase its revenue yield and to broaden the tax preferences covered by it.

The Act raises the minimum tax rate from 10 percent to 15 percent. In place of the existing $30,000 exemption and the deduction for regular income taxes, the Act has an exemption for individuals equal to one-half of regular income taxes or $10,000, whichever is greater. These changes reflect Congress' view that the effective tax rate on tax preferences should be higher.

Two new minimum tax preferences are added. To reduce the tax benefit of shelters in oil and gas drilling and to ensure that oil drillers pay some minimum income tax, the Act adds a preference for intangible drilling costs. To impose some tax in cases where there is excessive use of itemized personal deductions, there is a new preference for itemized deductions (other than medical expenses and casualty losses) in excess of 60 percent of adjusted gross income.

Congress also believed that the minimum tax on corporations should be strengthened in order to raise the effective tax rate on corporate tax preferences. However, because corporate income is subject to both the individual and corporate income taxes, Congress felt it was appropriate to retain in full the deduction for regular taxes for corporations.

Maximum tax

In 1969, Congress enacted a 50-percent maximum marginal tax rate on income from personal services. To reduce the incentive to invest in tax shelters, the law provided that income eligible for this maximum rate be reduced by tax preferences (as defined under the minimum tax) in excess of $30,000. The Act extends this 50-percent maximum rate to deferred compensation (including pensions and annuities).

The "preference offset" in the maximum tax has not been as effective in discouraging investment in tax shelters as originally planned. The expanded list of minimum tax preferences will make the preference offset more effective. Also, the Act repeals the existing $30,000 floor on preferences that reduce personal service income eligible for the maximum tax.

Business expenses under the individual income tax law

Many individuals are now claiming deductions for the business use of their home, for expenses related to the rental of their vacation homes for a brief part of the year, or for expenses of attending foreign conventions. While in theory there is nothing wrong with appropriate deductions for business or investment expenses, in practice it is often extremely difficult to allocate between deductible business expenses and nondeductible personal expenses. The result is that many people have been deducting amounts as business expenses which in part actually represent personal expenses. To deal with this problem, the Act places strict limitations on these deductions.

The Act also repeals the special tax treatment for qualified stock options. With personal service income subject to a maximum rate of 50 percent, Congress decided that there is no reason for not taxing this form of compensation as ordinary income.

Tax treatment of foreign income

The Act makes several important changes in the tax treatment of foreign income. Congress believed that it is necessary to strike a delicate balance between encouraging the free flow of capital across national borders and making sure that the tax laws do not provide excessive incentives for foreign investment instead of investment in the United States. Congress decided to retain the basic structure of the taxation of foreign income—namely, a foreign tax credit for income earned abroad and deferral of tax on income of foreign subsidiaries (except in the case of "tax haven" income) until returned to this country. However, the Act eliminates virtually all other tax-related incentives for investment abroad.

An important change made by the Act is the repeal of the per-country limitation on the foreign tax credit. The per-country limit enables a firm with a loss in one country and a profit in another to deduct the loss against U.S. income and still avoid U.S. tax on the profit through the foreign tax credit. Its repeal will eliminate this possibility and will also greatly simplify this part of the tax law. The Act also provides for recapture of foreign losses deducted from U.S. income when foreign profits are earned in subsequent years.

The Act repeals numerous tax incentives which favor investment in some foreign areas over others—those which favor investment in less-developed country corporations, China Trade Act corporations and Western Hemisphere trade corporations. It also substantially revises and improves the tax provisions relating to U.S. possessions. Except in the case of U.S. possessions, Congress felt that there was no longer any good reason for favoring investment in one of these foreign areas over another.

The Act, while retaining an exclusion for income earned abroad by individuals, eliminates special features of this provision enabling those with income above the basic exemption levels to obtain additional tax benefits from the exclusion and reduces the maximum amounts eligible for the exclusion. Congress did not feel that the tax preference for income earned abroad should be as large as it was under prior law.

Another area of concern is the DISC provision that permits deferral of tax for one-half of export income. To make this incentive more efficient, the Act limits DISC treatment to the excess of a firm's exports above a moving base period level.

Congress did not believe that multinational corporations should benefit from tax incentives when they engage in misconduct. Thus, the Act denies the foreign tax credit, tax deferral, and DISC treatment for income earned in connection with participation in international boycotts, such as the Arab boycott of Israel. Similarly, it provides that amounts paid as bribes by foreign subsidiaries will be taxed to the U.S. parent corporation.

To eliminate the possibility that oil companies which operate abroad gain undue advantage from the characterization of their payments to foreign governments as creditable taxes, the Act further limits the extent to which foreign tax credits from oil extraction can be used while continuing the requirement that these taxes may not reduce the tax on other foreign oil income.

The Act also makes several technical corrections that were considered necessary resulting from the changes in the taxation of foreign income made by the Tax Reduction Act of 1975.

Capital gains and losses

The Act makes three important changes in the tax treatment of capital gains and losses. The holding period defining long-term capital gains, which receive preferential tax treatment, is raised (over a period of two years) from six months to one year. This should encourage longer term investments as contrasted to short-term speculative investments. Also, the Act (over a period of two years) increases the amount of ordinary income against which capital losses can be deducted from $1,000 to $3,000. This change is designed to provide relief to those who have capital losses in excess of capital gains, which is not only fair but also should encourage individuals to make equity investments. Finally, the Act increases the exemption level for capital gains on the sale of a principal residence by a taxpayer age 65 or over.

Other tax revisions

The Act makes a large number of other relatively minor revisions in the tax law. These deal with inequities or technical problems that have come to the attention of the Congress.

There are several provisions relating to tax-exempt organizations. Among these is one which sets the payout requirement (if larger than actual earnings) for foundations at 5 percent of asset value (instead of a minimum of 6 percent) and provides that this limit is not to be varied as interest rates generally change. A second provision sets up a court review procedure where the IRS holds that an organization does not qualify for exempt status. A third change makes more specific the rules for lobbying by charitable and educational organizations.

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The Act includes a number of provisions relating to pensions. Probably the most important of these is one which expands the existing provision for individual retirement accounts (IRAs) to permit a working spouse to set up an IRA for a nonworking spouse. This change recognizes the contributions to the family made by nonworking spouses. If an IRA is set up for both spouses, a $1,750 contribution limit applies. Contributions can be made, subject to that limit, to a single IRA with separate subaccounts or two separate IRAs. Another pension provision permits an amount of up to $750 to be set aside each year in an H.R. 10-type plan where income is $15,000 or under without the amount set aside being limited to 25 percent of an individual's earnings.

There also are a number of changes relating to the taxation of insurance companies. Among these is one which, after a period of five years, will permit casualty insurance companies to file consolidated returns with life insurance companies but in a manner which does not permit the losses of the casualty companies to remove more than a limited amount of the life insurance income from taxation.

There are technical changes in the tax treatment of real estate investment trusts, housing cooperatives and condominiums, certain franchise transfers, authors and publishers, creditors of political parties, subchapter S corporations, the work incentive (WIN) tax credit, personal holding companies, oil and gas producers, losses from disasters, simultaneous liquidation of parent and subsidiary corporations, gain from sales or exchanges between related parties, and deductions for removing architectural and transportation barriers for handicapped and elderly people.

The Act makes revisions in depreciation rules designed to encourage rehabilitation of historic structures.

Several tax provisions that have recently expired are extended in the Act. These include rapid amortization provisions for pollution control facilities and rehabilitated low-income housing. Pollution control facilities are also given half of the normal investment credit, which differs from the prior provision under which 5-year amortization was an alternative to the investment credit. Congress believed that since Federal regulations require installation of pollution control equipment, it is equitable to reduce the cost of capital for such equipment. Also, the exclusion from income for certain forgiven student loans is extended through 1978. Further, the Act extends for a limited period the exclusion for certain health-related scholarships for members of the uniformed services for those participating in 1976.

Tax exemption is provided for contributions by employers to qualified group legal services plans, designed to encourage use of this fringe benefit.

To broaden the market for State and local government bonds, mutual funds are allowed to pass through tax-exempt interest on such bonds to shareholders.

Also, the Act redefines income or loss from writing options as short-term capital gain or loss in order to limit the tax shelters that have developed in recent years in stock option hedges.

In addition, the Act makes certain small changes in the excise tax treatment of truck modifications and truck parts and accessories, and simplifies and revises the excise tax treatment of cigars.

B. TAX SIMPLIFICATION

Tax simplification is the second major goal of the Act. Simplification must be an ongoing process, and the individual provisions of the tax law must be reexamined periodically to see how they contribute to the complexity of the tax law. Unless this reexamination occurs, the tax law will grow gradually more complicated as new provisions are added to achieve new goals of society. The Act repeals or restructures several provisions of the tax law, and directs that a Congressional study be made regarding further simplification of the tax system.

One such provision concerns the use of the income tax tables. The Act eliminates the existing tax tables based on adjusted gross income, which have been a major source of taxpayer error, and substitutes a simpler set of tables based on taxable income. It also raises to $20,000 the taxable income level where these tax tables may be used.

A second simplification concerns the retirement income credit. This was originally designed to give those who retire without social security a tax benefit similar to that accorded social security benefits. As a result, eligibility for the credit and its computation were designed to follow as closely as possible eligibility for, and computation of, social security benefits. This required a complex form that filled a whole page, and it is estimated that a large fraction of the people eligible for the credit either did not claim it or made errors in computing it. In response to this problem, Congress restructured the credit to eliminate virtually all the complexity, even though this means breaking the close link between the retirement income credit and social security eligibility. This new credit for the elderly also will be fairer than the retirement income credit under prior law since it will also be applicable to earned income for taxpayers age 65 or over.

Another complicated provision has been the sick pay exclusion. In this case, Congress concluded that the exclusion should be allowed only for persons who are permanently and totally disabled, since for other people there is no reason why sick pay should be treated more favorably than wage income, particularly in view of the deductibility of medical and drug expenses. For those still eligible for the sick pay exclusion, the provision has been considerably simplified and coordinated with the new credit for the elderly.

The Act makes major changes in the treatment of child and dependent care expenses. Formerly, these were allowed as an itemized deduction, subject to some complicated limitations. The Act converts the deduction into a 20-percent credit, so that it will be available to those who use the standard deduction as well as to itemizers and so that it will provide the same tax relief to taxpayers in low brackets as to those in high brackets. The child care deduction in prior law was worth, for examp'e, 70 cents for each dollar of child care expenses for a taxpayer in the 70-percent bracket, but only 14 cents to a low-bracket taxpayer who itemized deductions and nothing to someone who used the standard deduction. The new credit will be worth 20 cents for each dollar of qualified child care expenses for all taxpayers. In addition, the Act significantly simplifies the child care provision and broadens eligibility for it.

The Act makes several other changes that will simplify the law or make it more equitable, including a revision of the rules relating to accumulation trusts and the moving expense deduction. The alimony deduction is moved from an itemized deduction to a deduction in determining adjusted gross income, so that it can be used by people who take the standard deduction.

There are some cases where it is possible to achieve tax simplification without changing the substance of the law. The Act includes the so-called "deadwood provisions" which deletes obsolete and rarely used parts from the Internal Revenue Code and makes many other changes to shorten and simplify the language of the Code.

These provisions are only the beginning of what must be a continual process of tax simplification. Congress plans further tax simplication measures and has directed the Joint Committee on Taxation to conduct a comprehensive study of ways to simplify the tax system (with a report to the House Ways and Means and Senate Finance Committees due by June 30, 1977).

C. EXTENSION OF TAX REDUCTIONS

Economic conditions

A third major purpose of the Tax Reform Act of 1976 is to extend the fiscal stimulus provided by the Tax Reduction Act of 1975 and subsequently extended for the first half of 1976 by the Revenue Adjustment Act of 1975. The Tax Reduction Act of 1975 provided a tax cut, a tax rebate and increased expenditures totaling $23 billion in 1975.[1]

The 1975 tax cut included a temporary increase in the standard deduction and a $30 nonrefundable tax credit for each taxpayer and dependent, which reduced tax liability by $8 billion and was reflected in lower withheld and estimated tax payments over the last 8 months of 1975. There was also an earned income credit involving $1.4 billion and a home purchase credit amounting to about $0.6 billion. Finally, there were business tax reductions—an increase in the investment tax credit and a corporate rate cut for small businesses—amounting to $5 billion.

The 1975 increase in the standard deduction and the $30 credit, which reduced tax liability by $8 billion, were reflected in lower withheld and estimated tax payments over the last 8 months of 1975 at the rate of $1 billion per month, or $12 billion per year. In the Revenue Adjustment Act of 1975, Congress decided to extend these same withholding rates for the first half of 1976 and to provide a cut in tax liability for 1976 approximately equal to this $6 billion reduction in withholding. Also, that Act extended the small business tax cuts and the earned income credit for the first half of 1976. (The increase in the investment credit had been put into effect for 1975 and 1976 in the Tax Reduction Act.)

Congress analyzed economic conditions again in 1976 and believed it was inappropriate to withdraw the economic stimulus provided by the 1975 tax reductions. Due in no small part to the 1975–76 tax reduc-

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[1] This included a rebate on 1974 individual income taxes of $8.1 billion plus a $50 one-time payment to social security recipients and increased unemployment compensation amounting to $2 billion.

tions, there has been an overall economic recovery from the 1974–75 recession in the past 18 months. Output has grown at a rate of more than 6 percent, and we have exceeded the level of income and production that existed at the end of 1973, prior to the recession. Since then, however, the capacity of the economy has grown and will continue to grow, and the economic forecasts examined by Congress indicated that there is likely to be excess capacity in the economy for at least the next year. While the unemployment rate had fallen from 9 percent to 7.8 percent (at the time of passage of the Tax Reform Act), the existing unemployment rate was still considered to be unacceptably high. For these reasons, Congress agreed to extend the existing tax cuts at least through 1977 and to make part of the tax cuts permanent.

Congress did not believe that a permanent extension of the entire $20 million in tax reductions then in effect was appropriate. There was uncertainty about just how much excess capacity there was (or was likely to be) in the economy, how serious the inflation problem would be in the years ahead, as well as what budgetary requirements would be necessary for the rest of the decade.

In view of the uncertain economic and budgetary situation, Congress agreed to make part of the $20 billion tax reduction permanant but to extend the rest only temporarily. This will afford Congress and the Administration an opportunity in 1977 to review economic conditions and the fiscal requirements to see what, if any, further extensions or enlargements of these tax cuts should be made.

Individual tax reductions

The Act makes permanent $4 billion of individual tax reductions. These result from the increases in the standard deduction. The Act extends through 1977 the general tax credit adopted in the Revenue Adjustment Act and the earned income credit, which together involve a tax cut of $11 billion for 1977.

The Act permanently increases the minimum standard deduction (or low-income allowance) from $1,300 to $1,700 for single returns and to $2,100 for joint returns. It increases the percentage standard deduction from 15 percent to 16 percent. Also, it increases the maximum standard deduction from $2,000 to $2,400 for single returns and to $2,800 for joint returns. This will reduce tax liability at an annual rate of $4.2 billion for 1977, and will lower budget receipts in fiscal year 1977 by $4.1 billion. This increase in the standard deduction represents a major simplification of the individual income tax, since it will make it worthwhile for filers of 9 million tax returns to switch to the standard deduction. Also, this change creates greater tax equity, since itemized deductions have been free to rise with inflation, while the minimum and maximum standard deductions stay constant unless there is specific legislative action.

There is also an extension of the earned income credit through 1977. This is a refundable credit equal to 10 percent of the first $4,000 of earnings, with a phaseout as income rises between $4,000 and $8,000. It is available only to people with dependent children. It involves a cut in tax liability in 1977 at a rate of $1.3 billion, and a reduction in fiscal year 1977 budget receipts of $0.7 billion. The earned income credit provides a work incentive for those with jobs that pay relatively low wages. It provides desperately needed tax relief to a hard-pressed group, who are faced with high food and energy prices and are subject to the payroll tax.

The Act extends through 1977 the general tax credit for individuals adopted in the Revenue Adjustment Act, which reduces tax liability in 1977 at an annual rate of $10.1 billion. The extension of this credit will reduce fiscal year 1977 receipts by $9.5 billion. This credit equals the greater of $35 for each taxpayer and dependent or 2 percent of the first $9,000 of taxable income.

Together, the individual tax cuts amount to a cut in tax liability in 1977 at an annual rate of $15.6 billion. They will reduce budget receipts in fiscal year 1977 by $14.4 billion.

Business tax reductions

In order to provide sufficient economic stimulus and to encourage businesses to invest, the Act extends the business tax cuts provided by the Tax Reduction Act of 1975. These reduce tax liability in 1977 at an annual rate of $5.4 billion and will reduce tax receipts in fiscal year 1977 by $3.0 billion.

As discussed later under *Capital Formation*, the Act extends through 1980 the current 10-percent investment credit (applicable previously through 1976). This represents an increase from the previous 7-percent rate for most businesses and from the 4-percent rate for public utilities. These changes will reduce tax liability by $3.3 billion in 1977, and will lower budget receipts by $1.3 billion in fiscal year 1977.

The investment credit has proven an effective way to stimulate investment in equipment. Its enactment in 1962 and its reenactment in 1971 were followed by investment booms, and its suspension in 1966 and repeal in 1969 were followed by sharp declines in investment. Increased investment in the U.S. economy is needed to improve our standard of living and to achieve energy, environmental and other goals; and under these circumstances, Congress believed an extension of the 10-percent investment credit was appropriate. The credit for utilities is increased to the same rate as that for other businesses because Congress believed they should be able to compete for capital on the same basis as other industries.

The Act also extends through 1977 the small business tax cuts enacted in 1975. These increase the corporate surtax exemption from $25,000 to $50,000 and reduce the tax rate on the initial $25,000 of corporate income from 22 percent to 20 percent. The reduction in tax liability is $2.1 billion in 1977, and the reduction in budget receipts is $1.7 billion in fiscal year 1977. This change will improve the competitive position of small business.

D. CAPITAL FORMATION

A fourth major aspect of the Act is the encouragement of capital formation through the continuation and modification of certain investment-related tax incentives. Congress was concerned that the U.S. economy faced a severe shortage of capital. In 1973 and early 1974, there were capacity shortages in many major industries because investment in them had been inadequate in the previous five years. Also, the growth rate of labor productivity has slowed, again partly because of inadequate capital investment. We have had the most success in stimulating capital investment in recent years by the use of the investment tax credit. There appears to be a close correlation since 1962 between the presence of the investment credit and purchases of equipment. As a result, the Act extends the 10-percent investment credit for four years (or through 1980).

The Act extends and expands a provision enacted in 1975 allowing an additional one-percent investment credit if an equivalent amount is placed in an employee stock ownership plan. These changes should significantly increase the extent to which the provision is used by business. Under the new law, a credit of an additional one-half percentage point is also allowed if it is matched with employee contributions. This option is considered desirable in order to broaden employees ownership in business and thereby increase their interest in improving productivity. It will also serve the twin goals of increasing capital accumulation and creating a more equal distribution of wealth. To make the investment credit available to less profitable businesses, the Act makes it available on a first-in, first-out basis.

Another provision to promote capital accumulation, which will be especially important for new business, is one that extends the net operating loss carryforward period to 7 years. By allowing more flexibility in averaging profits and losses, this will encourage risktaking. It will also encourage investment in new businesses. The Act tightens the existing rules to prevent "trafficking" in losses in order to reduce any tax incentives toward business mergers. In addition, the capital loss carryover period for mutual funds is extended from 5 years to 8 years.

For railroads and airlines, industries which have had trouble generating internal funds as a result of the recession, the Act provides (for a limited period of time) a tax reduction through changes in the investment credit and in amortization rules. For similar reasons, at least half investment credit is made available to the domestic merchant marine for funds withdrawn from their tax-deferred ship construction fund to purchase ships.

Finally, the Act, in order to encourage domestic production, makes the investment credit available in the future for motion picture productions only where they are predominantly American-produced films. For the past, a compromise between the Internal Revenue Service and the industry is worked out as to the appropriate investment credit intended under the relatively uncertain provisions of prior law.

E. ADMINISTRATIVE PROVISIONS

A fifth major goal of the Act is to improve the administration of the tax laws. It contains several provisions to improve efficiency of tax administration through changes in withholding provisions and better regulation of tax return preparers. It also makes significant administrative changes designed to strengthen taxpayers' rights.

The Act provides definitive rules relating to the confidentiality of tax returns, an area where there has been abuse in the past. It strictly limits disclosure of information from tax returns. The ability of the Internal Revenue Service to use jeopardy and termination assessments and to issue administrative summons also is limited by providing better court review in these cases.

At the same time, rules are provided for the publication of private letter rulings so everyone will have an equal opportunity to know the view of the IRS on the proper interpretation of the tax law. New rules are also added to aid the Service in reviewing the way in which tax return preparers carry out their duties.

In the case of withholding tax provisions, a number of changes are made, including provision to withhold at the rate of 20 percent on income from most wagering where the amount won is $1,000 or over. Further, in the case of fishing vessels where the catch is shared, sternmen are classified as independent contractors for tax purposes. The Act also provides mandatory withholding of State and local income taxes for members of the Armed Forces.

F. ESTATE AND GIFT TAX PROVISIONS

The estate and gift tax provisions provide a comprehensive revision of these taxes. In this area, the Act provides substantial relief for moderate-sized estates, farms and other closely-held businesses, alleviates the liquidity problem for estates comprised largely of farms and other closely-held business, while at the same time it removes tax avoidance devices from the present system. This is accomplished with a balanced set of provisions which in the long run will at least maintain the present level of revenues.

The Act substantially reduces estate taxes for medium-sized estates. The existing $60,000 estate tax exemption was enacted in 1942 and since that time the percentage of decedents whose estates have been subjected to the Federal estate tax has increased from 1 percent to 8 percent. This increase has resulted from inflation and the greater ability of people to accumulate wealth because of the unprecedented economic prosperity in the post-war era. The Act increases from $60,000 to $175,000 the level at which the taxation of estates begins. It also changes the exemption into a tax credit in order to confer the maximum possible tax relief on the small and medium-sized estates.

In addition, the prior estate tax imposed acute problems when the principal asset of the estate was equity in a farm or small business. Because assets are valued at their "highest and best use" for estate tax purposes, rather than on the basis of the specific use to which the assets were being put (and also because these assets are illiquid), family members have often been forced to sell farms and small businesses in order to pay the estate tax. To deal with these problems the Act allows farms (and other family businesses) to be valued (to the extent of $500,000) at the value for farming purposes (or other small business use), if they remain in the family for a period of ten to fifteen years after the death of the decedent, rather than being valued at the "highest and best use" market value. Also, in these cases, the Act extends the time for payment of estate tax liability and provides for a low 4-percent interest rate on the tax on up to $1 million of farm or small business value. These changes are intended to preserve the family farm and other family businesses—two very important American institutions, both economically and culturally.

The estate and gift tax structure is an important part of the Federal tax system and as such needs to be as nearly equitable as possible in its application. Tax liability should not depend on the method used to transfer the property from one generation to the next. Because of this, a number of steps were taken to reform the estate and gift tax provisions. This reform provides assurance that in the long run these provisions will not lose revenue.

Two features of prior law which give rise to considerable variations in estate and gift tax burdens for people who transfer the same amount of wealth were the separate rate schedule and exemption provision for estates and gifts. There were several tax advantages to lifetime gifts. The gift tax rates were 75 percent of estate tax rates; and, unlike the estate tax, the amount of the gift tax itself was not included in the tax base. Also, someone who split his total transfers between gifts and bequests achieved the advantage of "rate splitting," since the first dollar of taxable bequests was taxed at the bottom estate tax rate even where there had been substantial lifetime gifts. These opportunities for reducting the overall burden by lifetime giving were inequitable, especially since many people are not wealthy enough to make lifetime gifts. The Act unifies the estate and gift taxes—both the exemptions (which have been converted into a credit) and the rates—to deal with these inequities.

Another cause of unequal treatment of taxpayers with the same amount of wealth transfers has been the ability to use "generation skipping" trusts. When weath is bequeathed from the parent to his child, then from the child to a grandchild and finally from the grandchild to a great-grandchild, the estate tax is imposed three times. However, if the parent places the wealth in a trust in which the child and then the grandchild has the right to the income from the trust, with the principal going to the great-grandchild, the parent will achieve virtually the same result and, in effect, skip two generations of estate tax. In these cases, the estate tax could be avoided for 100 years or more under prior law. Since such trust arrangements have been used largely by wealthier people, this failure to tax generation-skipping trusts has undermined the progressivity of the estate and gift taxes. The Act significantly limits estate tax avoidance through generation-skipping trusts by imposing a tax at the time of the death of the child or grandchild, in the example cited above, of substantially the same size as would be imposed had the property passed directly from the child to the grandchild and to the great-grandchild, although the additional tax in this case is payable by the trust. However, an exception to this rule is provided for up to $250,000 passing from a child to one or more grandchildren.

Still another inequity in the prior law resulted from the fact that when appreciated property was transferred at death, the basis of the property for the heirs (on which any capital gain or loss is computed) was the fair market value at the time of death rather than the basis of the decedent. This contrasted with the rule for gifts, where the donee must carry over the basis of the donor. One unfortunate result of the prior law has been that people were reluctant to sell appreciated property in anticipation of the step-up in basis at death. Another result has been that assets accumulated out of savings from ordinary income bore a heavier total tax burden than those resulting from appreciation in value where the gain had not been realized. To reduce the inefficiency and inequity of the prior system, the Act generally provides for a carryover basis at death but provides, however, that there will continue to be a step-up in basis for appreciation which has occurred through the end of the calendar year 1976.

G. INTERNATIONAL TRADE AMENDMENTS

Another area of the Act involves changes in the operation of the U.S. International Trade Commission and amendments to the Trade Act of 1974 regarding tariff treatment of countries aiding or abetting international terrorists.

The Congress concluded that the voting procedures of the International Trade Commission needed revising in order to facilitate the functioning of the Congressional override mechanism in cases where a plurality of three commissioners reached agreement on a particular remedy but, because a majority of the commissioners voting did not agree on a remedy, there was no "recommendation" by the Commission which Congress could implement under the override provisions (contained in the Trade Act of 1974). Thus, the Act provides that if a majority of the Commissioners voting on an escape clause or market disruption case cannot agree on a remedy finding, the remedy finding agreed upon by a plurality of not less than three Commissioners is to be treated as the remedy finding of the Commission for the purposes of the Congressional override mechanism. The Act also modifies the rule for the term of office for a member of the Commission so that a Commissioner may continue to serve after the expiration of the term of office until the successor is appointed and qualified.

In addition, the Act amends the Trade Act of 1974 to add a new category of reasons for denying preferential tariff treatment to "beneficiary developing countries." The new provision would prohibit preferential tariff treatment to such countries that aid or abet any individual or group which has committed an act of international terrorism. The President, however, could waive this prohibition (as he may for certain of the other categories for denial of preferential treatment) if a waiver is determined to be in the national economic interest of the United States.

II. REVENUE EFFECTS

Table 1 gives the revenue effects of the tax reform, estate and gift tax, and tax cut provisions of the Act, and lists the revenue impact of each title of the Act. As the table indicates, the tax reform provisions are estimated to raise about $1.6 billion in revenues in fiscal year 1977 and $2.5 billion by 1981. The tax cut extension amounts to $17.3 billion in 1977. The title-by-title analysis of the table indicates that $417 million of revenue will be raised from tax shelter provisions in 1977, a figure which rises to $527 million by 1981.

Table 2 lists the revenue effect of each section of the Act by title.

Tables 3 and 4 give the estimated decreases in individual income tax liability for calendar year 1977 and 1978 under the tax cut extensions contained in the Act.

TABLE 1.—REVENUE EFFECT OF TAX REFORM, ESTATE AND GIFT TAX, AND TAX CUT PROVISIONS OF THE ACT, SUMMARY AND BY TITLE [1]

[In millions of dollars; fiscal years]

	1977	1978	1979	1980	1981
SUMMARY					
Tax reform	1,593	1,719	2,038	2,118	2,470
Estate and gift tax		−728	−921	−1,134	−1,449
Extension of tax cuts	−17,326	−13,776	−7,966	−8,348	−7,212
Total	−15,733	−12,785	−6,849	−7,364	−6,191
BY TITLE					
II—Tax shelters	417	395	501	488	527
III—Minimum and maximum tax	1,095	1,283	1,464	1,603	1,758
IV—Extension of individual income tax reductions	−14,350	−9,293	−4,506	−4,731	−4,968
V—Tax simplification in the individual income tax	−409	−442	−457	−478	−499
VI—Business related individual income tax provisions	215	231	273	306	315
VII—Accumulation trusts	(2)	(2)	(2)	(2)	(2)
VIII—Capital formation	−1,457	−3,593	−3,796	−4,000	−2,499
IX—Small business provisions	−1,676	−1,177			
X—Changes in the treatment of foreign income	150	108	182	197	198
XI—Amendments affecting DISC	468	553	559	598	728
XII—Administrative provisions	88	55	55	55	55
XIII—Tax exempt organizations	−5	−5	(2)	(2)	(2)
XIV—Treatment of certain capital losses; holding period for capital gains and losses	−6	10	79	73	58
XV—Pension and insurance taxation	−18	−29	−29	−31	−30
XVI—Real estate investment trusts	(2)	(2)	(2)	(2)	(2)
XVII—Railroad provisions	−87	−139	−118	−98	−80
XVIII—International Trade Amendments					
XX—Estate and gift taxes		−728	−921	−1,134	−1,449
XXI—Miscellaneous provisions	−158	−14	−135	−212	−305
Total	−15,733	−12,785	−6,849	−7,364	−6,191

[1] Does not include Title I—Short Title and Title XIX—Repeal and Revision of Obsolete, Rarely Used, Etc., Provisions.
[2] Less than $5,000,000.

TABLE 2.—REVENUE EFFECT OF TAX REFORM, ESTATE AND GIFT TAX, AND TAX CUT PROVISIONS OF THE ACT, BY TITLE AND SECTION [1]

PART I. TAX REFORM

[In millions of dollars; fiscal years]

	1977	1978	1979	1980	1981
TITLE II					
Tax Shelters					
Real estate provisions:					
Sec. 201—Amortization of real property construction period interest and taxes	102	126	190	152	149
Sec. 202—Recapture of depreciation on real property	9	18	28	38	56
Sec. 203—5 year amortization of low income housing	−1	−4	−8	−8	−7
Farming provisions:					
Sec. 204—Limitation on deductions to amount at risk	(2)	(2)	(2)	(2)	(2)
Sec. 206—Termination of additions to excess deductions account	(2)	(2)	(2)	(2)	(2)
Sec. 207—Limitation on deductions for farming syndicates	86	32	32	33	34
Sec. 207—Accrual accounting for farm corporations	8	18	18	18	18
Sec. 214—Scope of waiver of statute of limitations in case of activities not engaged in for profit					
Oil and gas provisions:					
Sec. 204—Limitation on deductions to amount at risk	50	18	6	3	
Sec. 205—Gain from disposition of an interest in oil and gas property	7	14	42	51	65
Movie provisions:					
Sec. 204—Limitations on deductions to amount at risk	3	10	14	17	18
Sec. 210—Capitalization rules	29	19	9	4	4
Sec. 211—Clarification of definition of produced film rents	(2)	(2)	(2)	(2)	(2)
Equipment leasing provision: Sec. 204—Limitation on deductions to amount at risk	4	14	17	17	14
Sports franchise provisions:					
Sec. 212—Allocation of basis to player contracts	1	4	6	6	8
Sec. 212—Recapture of depreciation on player contracts	7	6	7	7	7
Partnership provisions:					
Sec. 213—Partnership syndication and organization fees	(2)	(2)	(2)	(2)	(2)
Sec. 213—Retroactive allocations of partnership income or loss	(2)	(2)	(2)	(2)	(2)
Sec. 213—Partnership special allocations	(2)	(2)	(2)	(2)	(2)
Sec. 213—Limitation on deductible losses of limited partners	(2)	(2)	(2)	(2)	(2)
Sec. 213—Limitation on additional first year depreciation for partnerships	12	10	10	10	10
Interest provisions:					
Sec. 208—Prepaid interest	(2)	(2)	(2)	(2)	(2)
Sec. 209—Limitation on deduction of nonbusiness interest	100	110	130	140	145
Other provisions: Sec. 214—Scope of waiver of statute of limitations in case of hobby loss elections	(2)	(2)	(2)	(2)	(2)
Total	417	395	501	488	527
TITLE III					
Minimum Tax and Maximum Tax					
Sec. 301—Minimum tax for individuals	1,032	1,135	1,249	1,373	1,511
Sec. 301—Minimum tax for corporations	59	124	185	194	204
Sec. 302—Maximum tax	4	24	30	36	43
Total	1,095	1,283	1,464	1,603	1,758
TITLE V					
Tax Simplification in the Individual Income Tax					
Sec. 501—Revision of tax tables for individuals					
Sec. 502—Deduction for alimony allowed in determining adjusted gross income	−7	−44	−49	−54	−59
Sec. 503—Revision of retirement income credit	−391	−340	−340	−340	−340
Sec. 504—Credit for child care expenses	−384	−368	−404	−444	−488
Sec. 505—Changes in exclusion for sick pay and certain military, etc., disability pensions	380	357	387	417	450
Disability payments for civilian Government employees for injuries resulting from acts of terrorism	(2)	(2)	(2)	(2)	(2)
Sec. 506—Moving expenses	−7	−47	−51	−57	−62
Sec. 507—Tax revision study by Joint Committee					
Total	−409	−442	−457	−478	−499

See footnotes at end of table.

TABLE 2.—REVENUE EFFECT OF TAX REFORM, ESTATE AND GIFT TAX, AND TAX CUT PROVISIONS [1] OF THE ACT BY TITLE AND SECTION [1]—Continued

[In millions of dollars; fiscal years]

	1977	1978	1979	1980	1981
TITLE VI					
Business-Related Individual Income Tax Provisions					
Sec. 601—Deductions for expenses attributable to business use of homes, rental of vacation homes, etc	207	206	235	268	305
Sec. 602—Deductions for attending foreign conventions	(2)	(2)	(2)	(2)	(2)
Sec. 603—Change in tax treatment of qualified stock options	7	20	33	33	5
Sec. 604—State legislators' travel expenses away from home	(3)	(3)	(3)	(3)	(3)
Sec. 605—Deduction for guarantees of business bad debts to guarantors not involved in business	1	5	5	5	5
Total	215	231	273	306	315
TITLE VII					
Accumulation Trusts					
Sec. 701—Accumulation trusts	(2)	(2)	(2)	(2)	(2)
TITLE VIII					
Capital Formation					
Sec. 802—First-in first-out treatment of investment credit amounts (for extension of 10-percent credit see Part III of this table)	(2)	(2)	−5	−20	−40
Sec. 803—Modifications in employee stock ownership plans	−107	−257	−303	−332	−189
Employee stock ownership plan regulations					
Study of expanded stock ownership					
Sec. 804—Investment credit in the case of movie and television films	[4] −37	[4] −18	[4] −13	[4] −13	−3
Sec. 805—Investment credit in the case of certain ships	−13	−12	−15	−18	−23
Sec. 806—Additional net operating loss carryover years; limitations on net operating loss carryovers	(2)	(2)	(2)	(2)	(2)
Sec. 807—Small fishing vessel construction reserves	(2)	(2)	(2)	(2)	(2)
Total	−157	−287	−336	−383	−255
TITLE IX					
Small Business Provisions					
Sec. 902—Liberalization of subchapter S rules governing number of shareholders	(2)	(2)	(2)	(2)	(2)
Liberalization of other subchapter S shareholder rules	(2)	(2)	(2)	(2)	(2)
Distributions by subchapter S corporation	(2)	(2)	(2)	(2)	(2)
TITLE X					
Changes in the Treatment of Foreign Income					
Part I—Foreign tax provisions affecting individuals abroad:					
Sec. 1011—Income earned abroad by U.S. citizens living or residing abroad	44	38	38	38	38
Sec. 1012—Income tax treatment of nonresident alien individuals who are married to citizens or residents of the United States	−1	−5	−5	−5	−5
Sec. 1013—Foreign trusts having one or more U.S. beneficiaries to be taxed currently to grantor	12	10	10	10	10
Sec. 1014—Interest charge on accumulation distributions from foreign trusts	(2)	(2)	(2)	(2)	(2)
Sec. 1015—Excise tax on transfers of property to foreign persons to avoid Federal income tax	(2)	(2)	(2)	(2)	(2)
Part II—Amendments affecting tax treatment of controlled foreign corporations and their shareholders:					
Sec. 1021—Amendment of provision relating to investment in U.S. property by controlled foreign corporations	(2)	(2)	(2)	(2)	(2)
Sec. 1022—Repeal of exclusion for earnings of less developed country corporations for purposes of section 1248	14	10	10	10	10
Sec. 1023—Exclusion from subpart F of certain earnings of insurance companies	−14	−10	−10	−10	−10
Sec. 1024—Shipping profits of foreign corporations	(2)	(2)	(2)	(2)	(2)
Limitation on definition of foreign base company sales income in the case of certain agricultural products					

See footnotes at end of table.

TABLE 2.—REVENUE EFFECT OF TAX REFORM, ESTATE AND GIFT TAX, AND TAX CUT PROVISIONS [1] OF THE ACT BY TITLE AND SECTION [1]—Continued

[In millions of dollars; fiscal years]

	1977	1978	1979	1980	1981
TITLE X—Continued					
Changes in the Treatment of Foreign Income—Continued					
Part III—Amendments affecting treatment of foreign taxes:					
Sec. 1031—Requirement that foreign tax credit be determined on overall basis	51	35	39	45	45
Sec. 1032—Recapture of foreign losses	2	8	14	22	28
Sec. 1033—Dividends from less developed country corporations to be grosses up for purposes of determining United States income and foreign tax credit against that income	80	55	55	55	55
Sec. 1034—Treatment of capital gains for purposes of foreign tax credit	14	10	10	10	10
Sec. 1035—Foreign oil and gas extraction income	−6	23	50	50	50
Sec. 1036—Underwriting income	([2])	([2])	([2])	([2])	([2])
Sec. 1037—Third-tier foreign tax credit when section 951 applies	−4	−10	−10	−10	−10
Part IV—Money or other property moving out of or into the United States:					
Sec. 1041—Portfolio debt investments in United States of nonresident aliens and foreign corporations	−55	−115	−125	−135	−145
Sec. 1042—Changes in ruling requirements under section 367; certain changes in section 1248	([2])	([2])	([2])	([2])	([2])
Sec. 1043—Continguous country branches of domestic life insurance companies	−12	−8	−8	−8	−8
Sec. 1044—Transitional rule for bond, etc., losses of foreign banks	([2])				
Part V—Special categories of foreign tax treatment:					
Sec. 1051—Tax treatment of corporations conducting trade or business in Puerto Rico and possessions of the United States	6	10	10	10	10
Sec. 1052—Western Hemisphere trade corporations	19	25	34	45	50
Sec. 1053—Repeal of provisions relating to China Trade Act corporations	([2])	([2])	([2])	([2])	([2])
Part VI—Denial of certain tax benefits on international boycotts and bribe-produced income	([2])	32	70	70	70
Total, title X	150	108	182	197	198
TITLE XI					
Amendments affecting DISC					
Sec. 1101—Amendments affecting DISC	468	553	559	598	728
TITLE XII					
Administrative provisions					
Sec. 1207—Withholding:					
Withholding of Federal tax on gambling winnings	101	68	68	68	68
Withholding of Federal tax on certain individuals engaged in fishing [6]	−13	−13	−13	−13	−13
Sec. 1212—Abatement of interest when return is prepared for Taxpayer by the International Revenue Service	([2])	([2])	([2])	([2])	([2])
Total	88	55	55	55	55
TITLE XIII					
Tax Exempt Organizations					
Sec. 1301—Disposition of private foundation property under transition rules of Tax Reform Act of 1969	([2])	([2])			
Sec. 1302—New private foundations set-asides	([2])	([2])	([2])	([2])	([2])
Sec. 1303—Minimum distribution amount for private foundations	([2])	([2])	([2])	([2])	([2])
Sec. 1304—Extension of time to amend charitable remainder trust governing instrument	−5	−5			
Sec. 1305—Unrelated trade or business income of trade shows, State fairs, etc.:					
Charitable organizations not subject to an unrelated business income tax on rental income from trade shows	([2])	([2])	([2])	([2])	([2])
County fairs not subject to an unrelated business income tax	([2])	([2])	([2])	([2])	([2])
Sec. 1306—Declaratory judgments with respect to section 501(c)(3) status and classification					
Sec. 1307—Lobbying by public charities	([2])	([2])	([2])	([2])	([2])
Sec. 1308—Tax liens, etc., not to constitute acquisition indebtedness	([2])	([2])	([2])	([2])	([2])

See footnotes at end of table.

TABLE 2.—REVENUE EFFECT OF TAX REFORM, ESTATE AND GIFT TAX, AND TAX CUT PROVISIONS[1] OF THE ACT BY TITLE AND SECTION[1]—Continued

[In millions of dollars; fiscal years]

	1977	1978	1979	1980	1981
TITLE XIII—Continued					
Tax Exempt Organizations—Continued					
Sec. 1309—Extension of self-dealing transition rules for private foundations	(2)	(2)	(2)	(2)	(2)
Sec. 1310—Imputed interest	(2)	(2)	(2)	(2)	(2)
Sec. 1311—Certain hospital services	(2)	(2)	(2)	(2)	(2)
Sec. 1312—Clinical services of cooperative hospitals	(2)	(2)	(2)	(2)	(2)
Sec. 1313—Exemption of certain amateur athletic organizations from tax	(2)	(2)	(2)	(2)	(2)
Total	−5	−5	(2)	(2)	(2)
TITLE XIV					
Treatment of Certain Capital Losses; Holding Period for Capital Gains and Losses					
Sec. 1401—Increase in amount of ordinary income against which capital loss may be offset	−22	−162	−248	−260	−273
Sec. 1402—Increase in holding period required for capital gain or loss to be long term	33	218	377	392	407
Sec. 1403—Allowance of 8-year capital loss carryover in case of regulated investment companies	−13	−21	−25	−34	−51
Sec. 1404—Sale of residence by elderly	−4	−25	−25	−25	−25
Total	−6	10	79	73	58
TITLE XV					
Pension and Insurance Taxation					
Sec. 1501—Retirement savings for certain married individuals	−2	−14	−15	−17	−17
Sec. 1502—Limitation on contributions to certain pension, etc., plans	(2)	(2)	(2)	(2)	(2)
Sec. 1503—Participation by members of reserves or national guard in individual retirement accounts, etc	−6	−5	−5	−5	−5
Participation by certain volunteer firemen in individual retirement accounts, etc	(2)	(2)	(2)	(2)	(2)
Sec. 1504—Certain investments by annuity plans	(2)	(2)	(2)	(2)	(2)
Sec. 1505—Segregated asset accounts					
Sec. 1506—Study of salary reduction pension plans					
Sec. 1507—Consolidated returns for life and other insurance companies					
Sec. 1508—Treatment of certain life insurance contracts guaranteed renewable	(3)	(3)	(3)	(3)	(3)
Sec. 1509—Study of expanded participation in IRA's					
Sec. 1510—Taxable status of Pension Benefit Guaranty Corporation					
Sec. 1511—Level premium plans covering owner-employees	(2)	(2)	(2)	(2)	(2)
Sec. 1512—Lump-sum distributions from qualified pension, etc., plans	−10	−10	−9	−9	−3
Total	−18	−29	−29	−31	−30
TITLE XVI					
Real Estate Investment Trusts					
Secs. 1601—1608—Real estate investment trusts	(2)	(2)	(2)	(2)	(2)
TITLE XVII					
Railroad and Airline Provisions					
Sec. 1701—Certain provisions relating to railroads	−29	−66	−65	−53	−41
Sec. 1702—Amortization over 50-year period of railroad grading and tunnel bores placed in service before 1969	−26	−18	−18	−18	−18
Sec. 1703—Certain provisions relating to airlines	−32	−55	−35	−27	−21
Total	−87	−139	−118	−98	−80
TITLE XVIII					
International Trade Amendments					
Sec. 1801—United States International Trade Commission					
Sec. 1802—Trade Act of 1974 Amendments					

See footnotes at end of table.

ABLE 2.—REVENUE EFFECT OF TAX REFORM, ESTATE AND GIFT TAX, AND TAX CUT PROVISIONS[1] OF THE ACT BY TITLE AND SECTION[1]—Continued

[In millions of dollars; fiscal years]

	1977	1978	1979	1980	1981
TITLE XXI					
Miscellaneous Provisions					
Sec. 2101—Tax treatment of certain housing associations	(2)	(2)	(2)	(2)	(2)
Sec. 2102—Treatment of certain disaster Payments	—48	—42	—42	—42	—42
Sec. 2103—Tax treatment of certain 1972 disaster losses	—60	—15	—15		
Sec. 2104—Tax treatment of certain debts owned by political parties, etc., to accrual basis taxpayers	(2)	(2)	(2)	(2)	(2)
Sec. 2105—Tax-exempt bonds for student loans	(2)	(2)	(2)	(2)	(2)
Sec. 2106—Personal holding company income amendments	(2)	(2)	(2)	(2)	(2)
Sec. 2107—Work incentive program expenses	—3	—7	—11	—14	—9
Sec. 2108—Repeal of excise tax on light-duty truck parts	—3	—3	—3	—3	—3
Sec. 2109—Exclusion from excise tax on certain articles resold after modification	(2)	(2)	(2)	(2)	(2)
Sec. 2110—Franchise transfers	(2)	(2)	(2)	(2)	(2)
Sec. 2111—Employers' duties in connection with the recording and reporting of tips	(2)	(2)			
Sec. 2112—Treatment of certain pollution control facilities	59	102	18	—70	—160
Sec. 2113—Clarification of status of certain fishermen's organizations	(2)	(2)	(2)	(2)	(2)
Sec. 2114—Application of section 6013(e) of the Internal Revenue Code of 1954	(2)	(2)			
Sec. 2115—Amendments to rules relating to limitation on percentage depletion in case of oil and gas wells	—24	—10	—10	—10	—10
Transfers of oil and gas property within the same controlled group or family	(2)	(2)	(2)	(2)	(2)
Sec. 2116—Implementation of Federal-State Tax Collection Act of 1972					
Sec. 2117—Cancellation of certain student loans	(2)	(2)	(2)	(2)	(2)
Sec. 2118—Treatment of gain or loss on sales or exchanges in connection with simultaneous liquidation of a parent and subsidiary corporation	(2)	(2)	(2)	(2)	(2)
Sec. 2119—Regulations relating to tax treatment of certain prepublication expenditures of publishers					
Sec. 2120—Contributions in aid of construction for certain utilities	—16	—11	—11	—11	—11
Sec. 2121—Prohibition of discriminatory State taxes on production and consumption of electricity					
Sec. 2122—Allowance of deduction for eliminating architectural and transportation barriers for the handicapped	—4	—10	—10	—6	
Sec. 2123—High-income taxpayer report					
Sec. 2124—Tax incentives to encourage the preservation of historic structures	—1	—3	—8	—12	—16
Sec. 2125—Amendment to Supplemental Security Income program					
Sec. 2126—Extension of carryover period for Cuban expropriation losses	(2)	(2)	(2)	(2)	(2)
Sec. 2127—Outdoor advertising displays					
Sec. 2128—Tax treatment of large cigars	—7	—7	—7	—7	—7
Sec. 2129—Treatment of gain from sales or exchanges between related parties	(2)	(2)	(2)	(2)	(2)
Sec. 2130—Application of section 117 to certain education programs for members of the uniformed services[6]	—10	—8	—8	—2	
Sec. 2131—Exchange funds	(2)	(2)	(2)	(2)	(2)
Sec. 2132—Contributions of certain Government publications	(2)	(2)	(2)	(2)	(2)
Sec. 2133—Tax incentives study					
Sec. 2134—Prepaid legal expenses	—5	—8	—16	—21	—33
Sec. 2135—Special rule for certain charitable contributions of inventory and other property	—19	—22	—22	—24	—24
Sec. 2136—Tax treatment of the grantor of options of stock, securities, and commodities	3	10	10	10	10
Sec. 2137—Exempt-interest dividends of regulated investment companies					
Sec. 2138—Common trust fund treatment of certain custodial accounts					
Sec. 2139—Support test for dependent children of divorced, etc., parents					
Sec. 2140—Involuntary conversions of real property	(2)	(2)	(2)	(2)	(2)
Sec. 2141—Livestock sold on account of drought	—20	20			
Total	—158	—14	—135	—212	—305
Total for Part I, Tax Reform	1,593	1,719	2,038	2,118	2,470

See footnotes at end of table.

TABLE 2.—REVENUE EFFECT OF TAX REFORM, ESTATE AND GIFT TAX, AND TAX CUT PROVISIONS [1] OF ACT BY TITLE AND SECTION—Continued

PART II. ESTATE AND GIFT TAX

[In millions of dollars; fiscal years]

	1977	1978	1979	1980	1981
TITLE XX					
Estate and Gift Taxes [7]					
Unified rates and credit		−541	−756	−1,012	−1,380
Marital deduction		−153	−162	−171	−181
Valuation		−14	−15	−16	−17
Extension of time		−20	−24	−28	−33
Unification	(*)	(*)	(*)	(*)	(*)
Generation skipping				(*)	(*)
Carryover of basis	(*)	(*)	36	93	162
Total		−728	−921	−1,134	−1,449

PART III. ETXENSION OF TAX REDUCTIONS

	1977	1978	1979	1980	1981
TITLE IV					
Extension of Individual Income Tax Reductions					
Sec. 401—Extensions of individual income tax reductions:					
(a) General tax credit	−9,509	−3,462			
(b) Standard deduction	−4,146	−4,481	−4,506	−4,731	−4,968
(c) Earned income credit	−695	−1,350			
Sec. 402—Refunds of earned income credit disregarded in the administration of Federal programs and federally assisted programs					
Total	−14,350	−9,293	−4,506	−4,731	−4,968
TITLE VIII					
Capital Formation					
Sec. 801—Extension of $100,000 limitation on used property for the investment credit	−38	−142	−149	−156	−118
Sec. 802—Extension of 10-percent investment credit	−1,262	−3,164	−3,311	−3,461	−2,126
Total	−1,300	−3,306	−3,460	−3,617	−2,244
TITLE IX					
Small Business Provisions					
Sec. 901—Extension of certain corporate income tax rate reductions	−1,676	−1,177			
Total for Part III, Extension of Tax Reductions	−17,326	−13,776	−7,966	−8,348	−7,212
Grand total, Parts I, II, and III	−15,733	−12,785	−6,849	−7,364	−6,191

[1] This table has omitted Title I—Short Title and Title XIX—Repeal and Revision of Obsolete, Rarely Used, Etc., Provisions.
[2] Less than $5,000,000.
[3] The revenue impact of this provision will not be very great; its magnitude, however, is not determinable because of lack of information regarding the practices of the State legislators during the period covered by the provision.
[4] Reflects liability of prior years.
[5] It is estimated that this provision will decrease budget receipts by $65,000,000 in the aggregate over the next 5 fiscal years.
[6] There is also an estimated $2,000,000 decrease in budget reccipts for fiscal year 1976 under this provision.
[7] The long-run estimates are as follows: unified rates and credit, −$1.23 billion; marital deduction, −$153 million; valuation, −$14 million; extension of time, less than $500,000; unification, $300 million; generation skipping, $280 million; carryover of basis, $1.08 billion; and total, $263 million.

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TABLE 3.—INDIVIDUAL INCOME TAX BURDEN[1] IN 1977 UNDER THE STANDARD DEDUCTION,[2] $35 PER CAPITA CREDIT, THE 2-PERCENT ALTERNATIVE CREDIT UP TO $180, AND THE 10-PERCENT EARNED INCOME CREDIT OF P.L. 94–455 COMPARED TO 1974 LAW

[Single person and married couple with 0, 1, 2, and 4 dependents (assuming deductible personal expenses of 17 percent of income).]

	Tax liability														
	Single person			Married couple with no dependents			Married couple with 1 dependent			Married couple with 2 dependents			Married couple with 4 dependents		
Adjusted gross income[3]	1974 law	Under P.L. 94–455	Reduction	1974 law	Under P.L. 94–455	Reduction	1974 law	Under P.L. 94–455	Reduction	1974 law	Under P.L. 94–455	Reduction	1974 law	Under P.L. 94–455	Reduction
$3,000	$138	$43	$95	$28	0	$28	0	−$300	$300	0	−$300	$300	0	−$300	−$300
$5,000	491	364	127	322	$130	192	$208	−300	508	$98	−300	398	0	−300	−300
$6,000	681	534	147	484	284	200	362	−67	429	245	−200	445	$28	−200	−228
$8,000	1,087	905	182	837	608	229	694	456	239	559	294	265	312	0	312
$10,000	1,482	1,331	151	1,152	948	204	1,010	821	189	867	651	216	586	308	278
$12,500	1,996	1,816	180	1,573	1,395	177	1,408	1,245	163	1,261	1,114	147	976	766	210
$15,000	2,549	2,369	180	2,029	1,849	180	1,864	1,684	180	1,699	1,519	180	1,371	1,161	210
$17,500	3,145	2,965	180	2,516	2,336	180	2,329	2,149	180	2,156	1,976	180	1,827	1,616	210
$15,000	2,549	2,369	180	2,029	1,849	180	1,864	1,684	180	1,699	1,519	180	1,371	1,161	210
$17,500	3,145	2,965	180	2,516	2,336	160	2,329	2,149	180	2,156	1,976	180	1,827	1,616	210
$20,000	3,784	3,604	180	3,035	2,855	180	2,848	2,668	180	2,660	2,480	180	2,285	2,075	210
$25,000	5,230	5,050	180	4,170	3,990	180	3,960	3,780	180	3,750	3,570	180	3,330	3,120	210
$30,000	6,850	6,670	180	5,468	5,288	180	5,228	5,048	180	4,988	4,808	180	4,508	4,298	210
$35,000	8,625	8,445	180	6,938	6,758	180	6,668	6,488	180	6,398	6,218	180	5,858	5,648	210
$40,000	10,515	10,335	180	8,543	8,363	180	8,251	8,071	180	7,958	7,778	180	7,373	7,163	210

[1] Computed without reference to the tax tables.
[2] Included the effect of a $1,700 to $2,100/16 percent/$2,400 to $2,800 standard deduction.
[3] Wage or salary and/or self-employment income.

Note: Details may not add to totals because of rounding.

TABLE 4.—INDIVIDUAL INCOME TAX BURDEN[1] IN 1978 UNDER THE STANDARD DEDUCTION[2] OF P.L. 94-455 COMPARED WITH 1974 LAW

[Single person and married couple with 0, 1, 2, 4, dependents (assuming deductible personal expenses of 17 percent of income)]

	Tax liability														
	Single person			Married couple with no dependents			Married couple with 1 dependent			Married couple with 2 dependents			Married couple with 4 dependents		
Adjusted gross income[3]	Under 1974 law	Under P.L. 94-455	Reduction	Under 1974 law	Under P.L. 94-455	Reduction	Under 1974 law	Under P.L. 94-455	Reduction	Under 1974 law	Under P.L. 94-455	Reduction	Under 1974 law	Under P.L. 94-455	Reduction
$3,000	$138	$78	$60	$28	0	—$28	0	0	0	0	0	0	0	0	0
5,000	491	415	76	322	$200	—122	$208	$91	—$117	$98	0	—$98	0	0	0
6,000	681	605	76	484	354	—130	362	238	—124	245	$126	—119	$28	0	—$28
8,000	1,087	1,016	71	837	696	—141	694	561	—133	559	434	—125	312	$200	—112
10,000	1,482	1,482	0	1,152	1,076	—76	1,010	934	—76	867	791	—76	586	518	—68
12,500	1,996	1,996	0	1,573	1,573	0	1,408	1,408	0	1,261	1,261	0	976	976	0
15,000	2,549	2,549	0	2,029	2,029	0	1,864	1,864	0	1,699	1,699	0	1,371	1,371	0
17,500	3,145	3,145	0	2,516	2,516	0	2,329	2,329	0	2,156	2,156	0	1,826	1,826	0
20,000	3,784	3,784	0	3,035	3,035	0	2,848	2,848	0	2,660	2,660	0	2,285	2,285	0
25,000	5,230	5,230	0	4,170	4,170	0	3,960	3,960	0	3,750	3,750	0	3,330	3,330	0
30,000	6,850	6,850	0	5,468	5,468	0	5,228	5,228	0	4,988	4,988	0	4,508	4,508	0
35,000	8,625	8,625	0	6,938	6,938	0	6,668	6,668	0	6,398	6,398	0	5,858	5,858	0
40,000	10,515	10,515	0	8,543	8,543	0	8,251	8,251	0	7,958	7,958	0	7,373	7,373	0

[1] Computed without reference to the tax tables.
[2] $1,700 or 16 percent of AGI up to $2,400 for singles and heads of households and $2,100 or 16 percent of AGI up to $2,800 for joints.
[3] Wage or salary and/or self-employment income.

III. GENERAL EXPLANATION OF THE ACT

A. TAX SHELTER PROVISIONS

1. Real Estate

a. Capitalization and Amortization of Real Property Construction Period Interest and Taxes (sec. 201 of the Act and sec. 189 of the Code)

Prior law

Prior to the Act, amounts paid for interest and taxes attributable to the construction of real property were allowable as current deductions except to the extent the taxpayer elected to capitalize these items as carrying charges (sec. 266).[1] If an election was made to capitalize these items, the amount capitalized was deductible over the useful life of the building. The deduction for taxes (sec. 164) includes sales and real estate taxes paid or accrued on real or personal property during the construction period. The deduction for interest during the construction period includes amounts designated as "points" or loan processing fees so long as these fees were paid by the borrower prior to the receipt of the loan funds and were not paid for specific services.[2] (Generally, construction period interest is not treated as investment interest for purposes of the limitation on investment interest (sec. 163(d)).[3]

Reasons for change

Prior to the Act, the tax provisions relating to real estate construction were used by taxpayers in high marginal income tax brackets to avoid payment of income tax on substantial portions of their economic income. This was principally achieved by allowing current deductions for costs which many believe are attributable to later years. For example, during the construction period the interest paid on the construction loan and the real estate taxes were immediately deducted even though there was no income from the property. These deductions resulted in losses which were used by taxpayers to offset income from other sources, such as salary and dividends. In effect, a taxpayer was allowed to defer or postpone the payment of tax on current income, either by offsetting current income with loss deductions attributable to real estate or by receiving a tax-free cash flow from the real estate

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[1] Interest paid or accrued during the construction period was deductible under the provisions dealing with the deductibility of interest in general (sec. 163).

[2] See Rev. Rul. 68–643 (C.B. 1968–2, 76), Rev. Rul. 69–188 (C.B. 1969–1, 54) and Rev. Rul. 69–582 (C.B. 1969–2, 29).

[3] Construction period interest also was not treated as a tax preference for purposes of the minimum tax in computing the preference for excess investment interest which was subject to the minimum tax until 1972 when the excess investment interest limitation provision became applicable.

project, or both. This deferral was the equivalent of an interest-free loan from the government, the economic benefits of which could be very significant.

The allowance of a deduction for construction period interest and taxes is contrary to the fundamental accounting principle of matching income and expenses. Generally, a current expense is deductible in full in the taxable year paid or incurred because it is necessary to produce income and is usually consumed in the process. However, some expenditures are made prior to the receipt of income attributable to the expenditures and, under the matching concept, these expenditures should be treated as a future expense when the income "resulting" from the expenditure is received and the original investment is gradually consumed.

In the case of an individual who constructs a building and subsequently receives income in the form of rents from that building, the accounting concept of matching income against expenses should require that the expenses incurred during the construction period be deducted against the rental income which is received over the life of the building, to the extent the expenses are attributable to a depreciable or wasting asset. The general construction costs of the building are treated this way, being capitalized and subsequently deducted as depreciation expenses. (Similarly, certain pre-opening or start-up expenses for a new trade or business are required to be capitalized for tax accounting purposes.) The interest and taxes paid during the construction period, however, were not capitalized under prior law except to the extent that the taxpayer elected to treat these items as carrying charges chargeable to capital account.

The allowance of a deduction for construction period interest and taxes contributed to the development of tax shelters in the real estate industry. Real estate ventures which were formed primarily to obtain tax shelter benefits essentially represent a misuse of intended tax incentives of longstanding and major importance. In addition, many feel that tax shelters may cause serious distortions in real estate values and construction costs, resulting in investments being made in projects that are economically unsound, and interfering with the efficient allocation of the nation's resources. Although it has been argued that the provisions of prior law providing incentives are essential to attract investment in an industry already suffering from a shortage of capital, the Congress concluded that allowing the full, immediate writeoff of construction period interest and taxes in these cases was not compatible with the objectives set out above.

As a result of the concern over the tax sheltering in real estate, the Congress decided, after a transition period, to require the capitalization of construction period interest and taxes and provide for the amortization of these items over a 10-year period, which deals directly with the preference providing the shelter while retaining some of the tax incentives for real estate investment by providing a shorter amortization period (10-years) than the useful life of the building.

Explanation of provision.

Under the Act, in the case of a taxpayer other than a corporation which is not a subchapter S corporation or a personal holding company,[4] real property construction period interest and taxes are to be capitalized in the year in which they are paid or accrued and amortized over a 10-year period. A portion of the amount capitalized may be deducted for the taxable year in which paid or accrued. The balance must be amortized over the remaining years in the amortization period beginning with the year in which the property is ready to be placed in service or is ready to be held for sale.

The prepaid interest rules provided under the Act are to be applied first to determine the period to which the interest relates. If under that provision, interest is treated as allocable to the construction period, the 10-year amortization rule is then to apply to that portion of the interest (in effect, for the purposes of this provision the interest is treated as paid or incurred in the year to which it is allocated under the prepaid interest rules).[5]

Construction period interest includes interest paid or accrued on indebtedness incurred or continued to acquire, construct, or carry real property to the extent attributable to the construction period for such property. The construction period commences with the date on which the construction of a building or other improvement begins and ends on the date that the building or improvement is ready to be placed in service or is ready to be held for sale. For this purpose, the construction period is not to be considered to have commenced solely because drilling is performed to determine soil conditions, architect's sketches or plans are prepared, or a building permit is obtained. Generally the construction period will be considered to have commenced when land preparations and improvements, such as clearing, grading, excavation, and filling, are undertaken. However, the construction period will not be considered to have commenced solely because clearing or grading work is undertaken, or drainage ditches are dug, if such work is undertaken primarily for the maintenance or preservation of raw land and existing structures and is not an integral part of a plan for the construction of new or substantially renovated buildings and improvements. In the case of the demolition of existing structures where the construction period has not otherwise commenced, the construction period is considered to commence when demolition begins if the demolition is undertaken to prepare the site for construction. The construction period will not be considered to commence solely because of the demolition of existing structures if the demolition is not undertaken as part of a plan for the construction of new or substantially renovated buildings or improvements.[6]

The provision is not to apply to any amount that is capitalized at the election of the taxpayer as a carrying charge (sec. 266). In addition, the provision is not to apply to interest or taxes paid or accrued

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[4] Since, except for subchapter S corporations and personal holding companies, this provision does not limit the deductibility of amounts paid or incurred by corporations, the provision is not to apply to corporations (other than subchapter S corporations and personal holding companies) which are partners in any partnership.

[5] However, in any case where construction period interest is also investment interest. (i.e., where the exception under sec. 163(d)(4)(D) for construction period interest does not apply), the construction period interest rules are to be applied first. Amounts allowable under the construction period rules for a taxable year are thus not to be subject to the investment interest provision until that year; if disallowed for that year unde rthe investment interest provision, these amounts can be deducted in succeeding years in accordance with the carryover rules of the investment interest provision.

[6] For purposes of this provision the growing of trees or other crops is not to be considered an improvement in real property.

with respect to property that is not held (or will not be held) for business or investment purposes (e.g., the taxpayer's residence).

Separate transitional rules are provided for non-residential real estate, residential real estate, and government-subsidized housing. In the case of nonresidential real estate, this provision is to apply to property where the construction period begins after December 31, 1975, with respect to amounts paid or accrued in taxable years beginning after 1975. In the case of residential real estate (other than certain low-income housing), this provision is to apply to construction period interest and taxes paid or accrued in taxable years beginning after December 31, 1977, and, in the case of low-income housing, to construction period interest and taxes paid or accrued in taxable years beginning after December 31, 1981. For this purpose, low-income housing means government housing entitled to the special rules relating to recapture of depreciation (under sec. 1250(a)(1)(B)).

In addition, the length of the amortization period is to be phased-in over a 7-year period. The amortization period is to be 4 years in the case of interest and taxes paid or accrued in the first year to which these rules apply. The amortization period increases by one year for each succeeding year after the initial effective date until the amortization period becomes 10 years (i.e., the 10-year period is fully phased-in for construction period interest and taxes paid or accrued in taxable years beginning in 1982, in the case of non-residential real estate; 1984, in the case of residential real estate; and 1988, in the case of government subsidized low-income housing). As a special transition rule for 1976 only, 50 percent of the amount paid or incurred may be deducted currently but, the remaining 50 percent is to be amortized over a 3-year period beginning in the year the property is ready to be placed in service or is ready to be held for sale.

The application of the general transitional rules and the phase-in of the amortization period can be illustrated by the following example. Assume that $120,000 of interest and taxes are paid or accrued in 1980 with respect to the construction of residential real estate (other than government subsidized low-income housing) and that the property is ready to be placed in service in 1982. For taxable year 1980, the $120,000 must be capitalized under this provision, but a deduction is to be allowed for $20,000 (1/6 of the amount capitalized). The remaining $100,000 (i.e., 5/6 of the total) is to be deducted ratably over a 5-year period beginning in 1982 (the year in which the property is ready to be placed in service). Thus, $20,000 is to be allowed as a deduction for taxable year 1982 and in each of the next succeeding 4 years.

In the case of a sale or exchange of real property, the unamortized balance of the construction period interest and taxes is to be added to the basis of the property for purposes of determining gain or loss on the sale or exchange. In the case of nontaxable transfer or exchange (i.e., a transfer to a partnership or controlled corporation, a like-kind exchange, or a gift), the transferor is to continue to deduct the unamortized balance allowable over the amortization period remaining after the transfer.

Effective date

In the case of nonresidential real estate, this provision is to apply only to property where the construction period begins after December 31, 1975, and only with respect to amounts paid or accrued in taxable years beginning after 1975. In the case of residential real estate (other than certain low-income housing), this provision is to apply to construction period interest and taxes paid or accrued in taxable years beginning after December 31, 1977, and, in the case of low-income housing to construction period interest and taxes paid or accrued in taxable years beginning after December 31, 1981. In each of these cases, phase-in rules of the amortization period are provided, as indicated above.

Revenue effect

The revenue gain from this provision is estimated to be $102 million for fiscal year 1977 and $149 million for fiscal year 1981.

b. Recapture of Depreciation on Real Property (sec. 202 of the Act and sec. 1250 of the Code)

Prior law

Generally, net gains on the sale of real property used in a trade or business (with certain exceptions) are taxed as capital gains, and losses are generally treated as ordinary losses. However, gain on the sale of depreciable real property (buildings) is generally "recaptured" and taxed as ordinary income rather than capital gain to the extent that the gain represents accelerated depreciation allowed or allowable in excess of the amount computed under the straight-line method of depreciation.

The provisions relating to depreciation recapture were first enacted in 1962 to prevent deductions for accelerated depreciation from converting ordinary income into capital gain. In general, the 1962 recapture provision (sec. 1245 of the code) provided that gain on a sale of most personal property would be taxed as ordinary income to the extent of all depreciation taken on the property after December 31, 1962. In 1964, recapture rules were extended to real property (buildings) to provide, in general, that gain on a sale would be taxed as ordinary income to the extent of the depreciation (in most cases only the accelerated depreciation) taken on that property after December 31, 1963. This provision (sec. 1250 of the code), however, had a gradual reduction of the amount to be recaptured. If the property had not been held for more than 12 months, all of the depreciation was recaptured. However, if the property had been held over 12 months, only the excess depreciation over straight-line was recaptured and the amount recaptured was reduced after an initial 20-month holding period at the rate of one percent per month. Thus, after 120 months (10 years) there was no recapture of any depreciation.

In the Tax Reform Act of 1969, the recapture rules on real property were further modified as to post-1969 depreciation. In the case of residential real property and property with respect to which the rapid depreciation for rehabilitation expenditures has been allowed, post-1969 depreciation in excess of straight-line was fully recaptured at ordinary income rates (to the extent of gain) if the property has been held for more than 12 months [7] but less than 100 months (8 years and 4

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[7] There was no change in the rule providing for recapture of all depreciation (including straight-line) if the property is not held for more than 12 months.

months). For each month the property was held over 100 months, there was a one percent reduction in the amount of post-1969 depreciation that was recaptured. Thus, there was no recapture of any depreciation if the property was held for 200 months (16 years and 8 months).

In the case of non-residential real property, all post-1969 depreciation in excess of straight-line depreciation is recaptured (to the extent there is gain) regardless of the length of time the property is held.

In addition, in the case of certain Federal, State, and locally assisted housing projects constructed, reconstructed, or acquired before January 1, 1976, such as the FHA 221(d)(3) and the FHA 236 programs, the pre-1969 recapture rules on real property were retained.[8] However, if the property was constructed, reconstructed, or acquired after December 31, 1975, the regular post-1969 rules previously discussed above with respect to residential property were to apply (i.e., a one percent reduction per month after 100 months).

Reasons for change

Generally, deductions for accelerated depreciation exceed the actual decline in the usefulness of the property. Further, accelerated methods of depreciation make it possible for taxpayers to deduct amounts in excess of the those required to service the mortgage during the early life of the property.

When the property is sold, the excess of the sales price over the adjusted basis was treated as capital gain to the extent that the recapture provisions did not apply. Under prior law, by holding residential rental property for 16⅔ years before sale, the taxpayer could arrange to have all gain resulting from excess depreciation (which was previously offset against ordinary income) taxed at the capital gain rates without any recapture.[9] The tax advantages for converting ordinary income into capital gain increase as the taxpayer's marginal income tax rate increases.

To reduce the opportunities to avoid income taxes as a result of allowing accelerated depreciation for real property to convert ordinary income into capital gain, the Congress decided that it is appropriate to extend the application of the present recapture rules on residential real estate. Under the Act, when residential real estate is sold, any gain will be recognized as ordinary income to the extent of accelerated depreciation previously allowed or allowable. In the case of low-income housing, however, the Congress decided that it is not desirable to require full recapture. In this way, in incentive is provided for owners of such housing to retain their ownership and operation of the properties for longer periods of time.

In addition, it came to the attention of the Congress that certain taxpayers have taken dilatory action to postpone foreclosure (or similar proceedings) on real property for the principal purpose of reducing the applicable percentage of accelerated depreciation that will be recaptured upon foreclosure (or similar proceeding). As a result of

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[8] That is, with respect to these projects, accelerated depreciation will be fully recaptured at ordinary income rates only if the property has been held for not more than 20 months. (If the property is sold within 12 months, all of the depreciation is recaptured.) For each month the property is held over 20 months, there is a 1 percent per month reduction in the amount of accelerated depreciation recaptured. Thus, there will be no recapture if the property is held for a period of 120 months (10 years).

[9] In the case of certain Federal, State, and locally assisted housing projects constructed, reconstructed, or acquired before January 1, 1976, there will be no recapture if the property is held for 10 years before sale.

this, the Congress decided to make the recapture rules apply in the case of real property from the date foreclosure proceedings are commenced.

Explanation of provision

In the case of residential real estate (other than certain low-income rental housing), the Act provides for the complete recapture of all post-1975 depreciation in excess of straight-line depreciation. (This rule already applies in the case of nonresidential, i.e., commercial property.) As under prior law, all of the depreciation taken, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months. Under the Act, all accelerated depreciation (depreciation in excess of straight-line) attributable to periods after December 31, 1975, will be fully recaptured to the extent of any depreciation in excess of straight-line regardless of the date the property was constructed. Special rules are provided in the case where a portion of the gain from the sale or exchange of property is subject to recapture under both the former recapture rules and the new recapture rules. Under these special rules, first, accelerated special rules, first, accelerated depreciation attributable to periods after December 31, 1975, will be recaptured (to the extent of any gain); second, accelerated depreciation attributable to periods after December 31, 1969, and before January 1, 1976, will be recaptured (to the extent of any additional gain not recaptured under the new rules); and third, accelerated depreciation attributable to periods after December 31, 1963, and before January 1, 1970 (to the extent of any remaining gain not recaptured).

The new rules providing for complete recapture of accelerated depreciation do not apply to 4 categories of low-income rental housing: (1) Federally assisted housing projects with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act (or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws); (2) low-income rental housing held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of State or local law authorizing similar levels of subsidy for lower income families; (3) low-income rental housing with respect to which a depreciation deduction for rehabilitation expenditures was allowed under section 167(k); and (4) Federally assisted housing with respect to which a loan is made or insured under title V of the Housing Act of 1949. As to these 4 categories of real property, all depreciation will be recaptured if the property has not been held for more than 12 months. However, if the property has been held for more than 12 months, no more than the excess depreciation over straight-time will be recaptured. For each month the property is held over 100 months, there will be a one percent per month reduction in the amount of accelerated depreciation attributable to periods after December 31, 1975, which is recaptured. Thus, after 200 months (16⅔ years) there will be no recapture.

Special rules similar to those discussed above are provided for Federally assisted housing projects with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act (or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws) where a portion of the gain from the sale or exchange of such property is subject to recapture under both the prior recapture rules and the new recapture rules.

In addition, the Act provides that where real property is disposed of by reason of foreclosure or similar proceedings, the monthly percentage reduction of the amount of accelerated depreciation subject to recapture are to terminate as of the date on which such proceedings were begun. The application of this provision can be illustrated by the following example:

Example.—Assume that on June 1, 1976, the taxpayer acquired certain low-income rental property which qualified for the special recapture treatment discussed above (i.e., a one percent per month reduction after 100 months). On April 1, 1987 (130 months after the property was placed in service) foreclosure proceedings were instituted with respect to the property and on December 1, 1988 (150 months after the property was placed in service) the property was disposed of pursuant to the foreclosure proceedings. The applicable percentage reduction will be 30 percent rather than 50 percent since the percentage reduction would cease to apply on April 1, 1987 (the date that foreclosure proceedings were instituted).

Effective date

The provisions relating to the complete recapture of depreciation apply to accelerated depreciation attributable to taxable years beginning after December 31, 1975. The provisions relating to the percentage reduction in the case of dispositions pursuant to foreclosure or similar proceedings shall apply with respect to proceedings which begin after December 31, 1975.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of $9 million for fiscal year 1977, and $56 million for 1981.

c. Five-Year Amortization for Low-Income Rental Housing (sec. 203 of the Act and sec. 167 of the Code)

Prior law

Under the code, special depreciation rules are provided for expenditures to rehabilitate low income rental housing (sec. 167(k) of the code). Low-income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income. Under current Treasury regulations occupants of a dwelling unit are considered families and individuals of low or moderate income only if their adjusted income does not exceed 90 percent of the income limits described by the Secretary of Housing and Urban Development (HUD) for occupants of projects financed with certain mortgages insured by the Federal Government. The level of eligible income varies according to geographical area.[10]

Under the special depreciation rules for low income rental property, taxpayers can elect to compute depreciation on certain rehabilitation

[10] The current income limits prescribed by the Secretary of HUD for a family of four are $15,400 in Washington, D.C., $13,700 in Chicago, and $11,900 in Los Angeles. Thus, 90 percent of these limits are $13,800, $12,330, and $10,710 respectively.

expenditures under a straight-line method over a period of 60 months if the additions or improvements have a useful life of 5 years or more. Under prior law, only the aggregate rehabilitation expenditures as to any housing which do not exceed $15,000 per dwelling unit qualified for the 60-month depreciation. In addition, for the 60-month depreciation to be available, the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed $3,000 per dwelling unit.

Reasons for change

In the Housing and Community Development Act of 1974, the Congress expressed its desire to stimulate construction in low-income rental housing to eliminate the shortage in the area. However, the special tax incentive for rehabilitation expenditures for low-income rental housing under present law expired on December 31, 1975. Without this incentive the remodeling of many high-risk low-income projects would have been curtailed. In order to avoid discouraging this rehabilitation, the Congress believed that the special depreciation provision for low-income housing should be extended.

Explanation of provision

The Act provides a two-year extension of the special 5-year depreciation rule for expenditures to rehabilitate low-income rental housing and increases the amount of rehabilitation expenditures that can be taken into account per dwelling unit from $15,000 to $20,000.

Under the Act, rehabilitation expenditures that are made pursuant to a binding contract entered into before January 1, 1978, would qualify for the 5-year depreciation rule even though the expenditures are actually made after December 31, 1977.

In addition, the Act modifies the definition of families and individuals of low and moderate income by providing that the eligible income limits are to be determined in a manner consistent with those presently established for the Leased Housing Program under Section 8 of the United States Housing Act of 1937, as amended.

Effective date

The provisions relating to the 2-year extension apply to expenditures paid or incurred with respect to low-income rental housing after December 31, 1975, and before January 1, 1978 (including expenditures made pursuant to a binding contract entered into before January 1, 1978). The provisions increasing the amount of expenditures that can be depreciated under the special 5-year rule apply to expenditures incurred after December 31, 1975.

Revenue effect

It is estimated that the provision will result in a decrease in budget receipts of $1 million for fiscal year 1977, and $7 million for 1981.

2. Limitation of Loss to Amount At-Risk (sec. 204 of the Act and sec. 465 of the Code)

Prior law

Generally, the amount of depreciation or other deductions which a taxpayer has been permitted to take in connection with a property has been limited to the amount of his basis in the property. Similar statutory limitation rules are found in sections 704(d) and 1374(c)(2) for owners of partnership interests and shareholders in subchapter S corporations where the partners and shareholders, rather than the entity, are taxed on the income or loss of the entity.

The starting point for determining a taxpayer's adjusted basis in a productive activity or enterprise is generally the taxpayer's cost for the assets used in the activity or enterprise (secs. 1011, 1012). In the case of a productive activity engaged in through a partnership or subchapter S corporation, the investor's adjusted basis in his stock or partnership interest is generally based on the amount of money and his adjusted basis in other property contributed to the enterprise (secs. 722, 358). The investor's basis in a partnership interest or subchapter S corporation stock is increased by his portion of the income of these entities, and decreased by his portion of their losses, in recognition of the fact that the income and losses are flowed through to the investor for tax purposes, rather than being taxed to the entity.

The liabilities of a productive activity may also have an effect upon an investor's adjusted basis in the activity. Thus, a taxpayer's basis in a property includes the portion of the purchase price which is financed even if the taxpayer is not personally liable on the loan and the lender must look solely to the financed property for repayment of the loan.

However, in the case of a subchapter S corporation, liabilities of the corporation increase a shareholder's adjusted basis in the stock only to the extent that the liability is owed to that particular shareholder (secs. 1374(c)(2), 1376).

In the case of partnerships, in general, a partner's share of the liabilities of the partnership is considered to be a contribution of money by him to the partnership (sec. 752). Since a partner's contributions to the partnership increase the adjusted basis of his partnership interest (sec. 705), the partner's adjusted basis reflects not only his contributions in money and other property, but also his share of partnership liabilities. This rule applies regardless of whether the particular liability is owed to one or more of the partners or to an unrelated party.

The rule is premised upon the assumption that the partner may be held personally liable for the debts of the partnership and since he may be called on to, in effect, make additional contributions of money to cover these liabilities, the adjusted basis of his partnership interest should reflect this potential risk of additional liability.

However, a limited partner in a limited partnership may not be held responsible for partnership debts, and his potential personal liability is confined to any additional amount he is required to contribute to the partnership by the partnership agreement. Since a limited partner does not have unlimited personal liability, the basis of his partnership interest is not usually increased to reflect borrowing by the partnership. There has been, however, an exception to this rule. The regulations provide that where none of the partners have personal liability for a partnership obligation, all of the partners, including limited partners share in the liability (Reg. § 1.752–1(e)). Since a limited partner is deemed to have a share of such nonrecourse liabilities, the adjusted basis of his partnership interest is increased under the generally applicable partnership provisions.

This approach to nonrecourse partnership liabilities arose from a judicially developed principle known as the *Crane* rule. The *Crane* rule was derived from the Supreme Court's reasoning in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), where it was held that an owner's adjusted basis in a parcel of real property included the amount of a nonrecourse mortgage on the property, under which the mortgagee-lender could seek a recovery of its loan only from the property. (It is because of the *Crane* rule that nonrecourse indebtedness has generally been included in an investor's adjusted basis, as indicated above, in a business or productive property.)

Also, in general, the existence of protection against ultimate loss by reason of a stop-loss order, guarantee, guaranteed repurchase agreement or similar arrangement does not generally impose a limitation on the amount of losses a taxpayer may deduct in the early taxable years of an activity.

Reasons for change

The typical tax shelter has operated as a limited partnership with individual investors participating as limited partners. Virtually all of the equity capital for the activity has been contributed by the limited partners with the major portion of the remaining operating funds (generally 75 percent or more of the total capital) for the partnership financed through nonrecourse loans.

When an investment had been solicited for a tax shelter activity, it had been common practice to promise the prospective investor substantial tax losses which could be used to decrease the tax on his income from other sources. The opportunity to deduct tax losses in excess of the amount of the taxpayer's economic risk had arisen under prior law primarily through the use of nonrecourse financing not only by limited partnerships, but also by individuals and subchapter S corporations. The ability to deduct tax losses in excess of economic risk had also arisen through guarantees, stop-loss agreements, guaranteed repurchase agreements, and other devices used by the partnerships, individuals and subchapter S corporations.

Nonrecourse leveraging of investments and other risk limiting devices which produce tax savings in excess of amounts placed at risk substantially alter the economic substance of the investments and distort the workings of the investment markets. Taxpayers, ignoring the possible tax consequences in later years, can be led into investments which are otherwise economically unsound and which constitute an unproductive use of investment funds.

Congress believed that it was not equitable to allow individual investors to defer tax on income from other sources through losses generated by tax sheltering activities. One of the most significant problems in tax shelters was the use of nonrecourse financing and other risk-limiting devices which enabled investors in these activities to deduct losses from the activities in amounts which exceeded the total investment the investor actually placed at risk in the activity. The Act consequently provides an "at risk" rule to deal directly with this abuse in tax shelters.

Explanation of provision

To prevent a situation where the taxpayer may deduct a loss in excess of his economic investment in certain types of tax shelter activities, the Act provides that the amount of any loss (otherwise allowable for the year) which may be deducted in connection with one of these activities cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. This "at risk" limitation applies to the following activities: (1) farming[1]; (2) exploring for, or exploiting, oil and gas resources; (3) the holding, producing, or distributing of motion picture films or video tapes; and (4) equipment leasing. The limitation applies to all taxpayers (other than corporations which are not subchapter S corporations or personal holding companies) including individuals and sole proprietorships, estates, trusts, shareholders in subchapter S corporations, and partners in a partnership which conducts an activity described in this provision.[2]

The at risk limitation is to apply on the basis of the facts existing at the end of each taxable year. The at risk limitation applies regardless of the method of accounting used by the taxpayer and regardless of the kind of deductible expenses which contributed to the loss.

The amount of any loss which is allowable in a particular year reduces the taxpayer's at risk amount as of the end of that year and in all succeeding taxable years with respect to that activity.[3]

Losses which are suspended under this provision with respect to a taxpayer because they are greater than the taxpayer's investment which is "at risk" are to be treated as a deduction with respect to the activity in the following year. Consequently, if a taxpayer's amount at risk increases in later years, he will be able to obtain the benefit of previously suspended losses to the extent that such increases in his amount at risk exceed his losses in later years.

The at risk limitation is only intended to limit the extent to which certain losses in connection with the covered activities may be deducted in the year they would otherwise be allowable to the taxpayer. The rules of this provision do not apply for other purposes, such as the determination of basis. Thus, a partner's basis in his interest in the partnership will generally be unaffected by this provision of the committee amendment.[4] However, for purposes of determining how much, if any, of his share of a partnership loss from the enumerated activities a partner may deduct in any year, this provision of the Act overrides the existing partnership rules of section 704(d) and related provisions, including regulations section 1.752–1(e).[5]

For purposes of this provision, a taxpayer is generally to be con-

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[1] For purposes of this section, the definition of "farming" is the definition used in the farming syndicate rules (discussed below). Thus, the at risk provision does not apply to forestry or the growing of timber.

[2] Since, except for subchapter S corporations and personal holding companies, this provision does not limit the deductibility of amounts paid or incurred by corporations, the provision would not apply to a partnership in which all the partners are corporations (other than subchapter S corporations or personal holding companies). Similarly, if a partnership is comprised of both individual partners and corporate partners (other than subchapter S corporations and personal holding companies), the at risk provision applies to the individual partners but not the corporate partners.

[3] The at risk limitation does not affect a taxpayer's utilization of the investment credit. Also, the amount of investment tax credit claimed by a taxpayer with respect to an activity does not reduce the amount the taxpayer is at risk with respect to the activity.

[4] For example, the basis of a partner's interest in a partnership is reduced by the full amount of any losses which would be allowable but for this provision. However, upon disposition of his interest in a partnership, a partner is to be treated as becoming at risk with respect to the amount of any gain from the disposition. As a result, a partner will be able to deduct any suspended losses at the time of disposition.

[5] If no partner is personally liable to repay any part of a debt obligation incurred by the partnership, no partner may treat such part of the debt as part of his capital at risk in the partnership for purposes of this provision. Similarly, even if one or more partners is personally liable on part or all of a partnership debt, other partners who have no personal liability may not treat any part of the debt as part of their risk capital. In the case of a partnership, special allocations of deductions by agreement among the partners may not increase the amount of a loss deduction allowable to any partner for a taxable year beyond the amount which that partner is "at risk" in the partnership for the same year.

sidered "at risk" with respect to an activity to the extent of his cash and the adjusted basis of other property contributed to the activity, as well as any amounts borrowed for use in the activity with respect to which the taxpayer has personal liability for payment from his personal assets.

A taxpayer's at risk amount is also generally to include amounts borrowed for use in the activity which are secured by property other than property used in the activity. For example, if the taxpayer acting as a sole proprietor (or partner or shareholder in a subchapter S corporation) uses personally-owned real estate to secure nonrecourse indebtedness, the proceeds from which are used in an equipment leasing activity, the proceeds may be considered part of the taxpayer's at risk amount. In such a case, the portion of the proceeds which increases the taxpayer's at risk amount is to be limited by the fair market value of the property used as collateral (determined as of the date the property is pledged as security), less any prior (or superior) claims to which the collateral is subject.

The Act contains a special rule which prevents a taxpayer from increasing his at risk amount through collateral in cases where the collateral was financed directly or indirectly by indebtedness which is secured by any property used in the activity. The intent of this rule is to prevent a taxpayer from increasing his at risk amount by cross-collateralizing property used in the activity with other property not used in the activity.

Except where the indebtedness is secured by property not used in the activity, a taxpayer is not to be considered at risk with respect to the proceeds from his share of any nonrecourse loan used to finance the activity or the acquisition of property used in the activity. In addition, if the taxpayer borrows money to contribute to the activity and the lender's only recourse is either the taxpayer's interest in the activity or property used in the activity, the amount of the proceeds of the borrowing are to be considered amounts financed on a nonrecourse basis and do not increase the taxpayer's amount at risk.

Also, under these rules, a taxpayer is not to be "at risk," even as to the equity capital which he has contributed to the activity, to the extent he is protected against economic loss of all or part of such capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer.[6] Under this concept, a taxpayer is not "at risk" if he arranges to receive insurance or other compensation for an economic loss after the loss is sustained, or if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person.[7]

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[6] The normal buy-sell agreement between partners which is carried out when a partner retires or dies is not the kind of agreement which prevents a partner from being at risk.

[7] In livestock feeding operations, for example, some commercial feedlots have offered to reimburse investors against any loss sustained on sales of the fed livestock above a stated dollar amount per head. Under such "stop loss" orders, the investor is to be considered "at risk" (for purposes of this provision) only to the extent of the portion of his capital against which he is not entitled to reimbursement. Similarly, in some livestock breeding investments carried on through a limited partnership, the partnership agrees with a limited partner that, at the partner's election, it will repurchase his partnership interest at a stated minimum dollar amount (usually less than the investor's original capital contribution). In situations of this kind, the partner is to be considered "at risk" only to the extent of the portion of the amount otherwise at risk over and above the guaranteed repurchase price.

In addition a limited partner who assumes personal liability on a loan to the partnership (made by a bank or other lender) but who obtains the general partner's agreement to indemnify him against some or all of any loss arising under such personal liability, is at risk only with respect to the excess of the amount of the indebtedness over the maximum amount covered by the indemnity agreement.

Similarly, if a taxpayer is personally liable on a mortgage but separately obtains insurance to compensate him for any payments which he must actually make under such personal liability, the taxpayer is at risk only to the extent of the uninsured portion of the personal liability to which he is exposed.[8] The taxpayer will be able to include in the amount which he has at risk any amount of nondeductible premium which he has paid from his personal assets with respect to the insurance. However, a taxpayer who obtains casualty insurance or insurance protecting himself against tort liability will not be considered "not at risk" solely because of such hazard insurance protection.

In the case of a partnership, a partner is generally to be treated as at risk to the extent that his basis in the partnership is increased by his share of partnership income.[9] The fact that partnership income is then used to reduce the partnership's nonrecourse indebtedness would have no effect on the partner's amount at risk. (The reduction of nonrecourse indebtedness would still, of course, reduce his basis in his partnership interest for purposes other than the at risk limitation.)[10] If the partnership, instead of retaining the income, makes actual distributions of the income to a partner in the taxable year, the amount distributed, like any cash distribution, reduces the partner's amount at risk.

In general, in the case of an activity engaged in by an individual, each motion picture film or video tape, item of leased equipment, farm, or oil and gas property is treated as a separate activity. However, in the case of a partnership, personal holding company, or subchapter S corporation, all of the activities of the same type (e.g., all motion picture films and video tapes) are to be treated as one activity.[11] Thus, where the partnership is engaged in only one type of activity the loss from the activity for any partner is that partner's loss from the partnership and (assuming no stop loss orders, etc.) his at risk amount is generally the amount of his cash or other contribution to the partnership, plus his share of any indebtedness with respect to which the partner has no limitation on liability.

The at risk limitation applies only to losses produced by deductions which are not disallowed by reason of some other provision of the Code. For example, if a prepaid interest expense is suspended under the prepaid interest limitation (sec. 208 of the Act and sec. 461 of the Code) that expense will not enter into the computation

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[8] For purposes of this rule, it will be assumed that a loss-protection guarantee, repurchase agreement or insurance policy will be fully honored and that the amounts due thereunder will be fully paid to the taxpayer. The possibility that the party making the guarantee to the taxpayer, or that a partnership which agrees to repurchase a partner's interest at an agreed price, will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) is not to be material unless and until the time when the taxpayer becomes unconditionally entitled to payment and, at that time, demonstrates that he cannot recover under the agreement.

[9] However, his at risk amount must be reduced by any personal nonrecourse indebtedness reflected in his basis and any other appropriate stop-loss orders, etc., which affect his risk or that of his partnership.

[10] For example, assume partner A's basis in the partnership is $60X (consisting of $10X which is "at risk" and $50X which represents the portion of the partnership's nonrecourse loan which is allocated to partner A's basis). If the partnership has $5X of taxable income for the taxable year which is allocated to partner A, his total basis is increased to $65X (his at risk basis increases to $15X while his basis which is not at risk remains at $50X). If the partnership then makes a $5X payment to the bank on its loan, the partner's basis is reduced to $60X (his at risk basis remains at $15X while his basis which is not at risk is reduced to $45X).

[11] Partnerships engaged in two or more different types of activities, such as movies and equipment leasing, or movies and farming are to be treated as having that number of activities, and the at risk limitation is determined separately for each activity.

of the loss subject to the at-risk limitation. When the interest accrues and becomes deductible, the expense may at that time be subject to this provision. Similarly, if a deduction is deferred pursuant to the farming syndicate rules (described below), that deduction will enter into the computation of the tax loss subject to the at risk limitation only when it becomes deductible under the farming syndicate rules.

The Act specifically requires that a taxpayer not be considered at risk with respect to amounts borrowed for use in an activity (or which are contributed to the activity)[12] where the amounts are borrowed from any person who has an interest in the activity (other than that as a creditor) or who is related to the taxpayer (as described in sec. 267(b)). Persons having an interest in the activity include, in the case of a partnership, all other partners and any other person (such as a promoter or selling agent) who stands to receive financial gain from the activity or from the sale of interests in the activity. Those persons considered to be related to the taxpayer include the taxpayer's spouse, ancestors and lineal descendants, brothers and sisters, and corporations and other entities in which the taxpayer has a 50-percent or greater interest.[13]

Effective dates

In general, the at risk provision applies to losses attributable to amounts paid or incurred (and depreciation or amortization allowed or allowable) in taxable years beginning after December 31, 1975. However, with respect to equipment leasing activities, the at risk rule generally does not apply where the property was subject to a net operating lease and binding contracts were finalized on or before December 31, 1975, and similarly to operating lease transactions under binding contracts finalized on or before April 30, 1976.

With respect to motion picture activities, the at risk provision does not apply to a film purchase shelter if the principal photography began before September 11, 1975, there was a binding written contract for the purchase of the film on that date, and the taxpayer held his interest in the film on that date. The at risk rule also does not apply to production costs, etc., if the principal photography began before September 11, 1975, and the investor had acquired his interest in the film before that date. In addition, the at risk provision does not apply to film produced in the United States if the principal photography began before January 1, 1976, if certain commitments with respect to the film had been made by September 10, 1975.

In applying the at risk provisions to activities which were begun in taxable years beginning before January 1, 1976 (and not exempted from this provision by the above transition rules), amounts paid or incurred in taxable years beginning prior to that date and deducted in such taxable years will generally be treated as reducing first that por-

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[12] The amounts borrowed by the taxpayer and then contributed to the activity (or used to purchase property which is contributed to the activity) are "amounts borrowed with respect to" the activity (as referred to in section 465(b)(1)(B)) and therefore are subject to the rules of section 465(b)(3) even though such amounts (or property) are also described in section 465(b)(1)(A).

[13] While this rule applies to loans from a partner to the partnership for purposes of determining the at risk amount of the other partners (resulting from the increase in partnership liabilities), it is not to affect any possible allocation of basis and at risk amounts which otherwise might be made to a specific partner in cases where that partner has borrowed funds from the partnership (or is otherwise obligated to the partnership).

tion of the taxpayer's basis which is attributable to amounts not at risk. (On the other hand, withdrawals made in taxable years beginning before January 1, 1976, will be treated as reducing the amount which the taxpayer is at risk.)[14]

Revenue effect

The provision will increase budget receipts by $57 million in fiscal year 1977, $42 million in fiscal year 1978, and $38 million in fiscal year 1981.

3. Farm Operations

a. Farming Syndicates (sec. 207 (a) and (b) of the Act and secs. 278 and 464 of the Code)

Prior law

Under the tax laws, farm operations are governed by special tax rules, many of which confer tax benefits on farming activities and on persons who engage in farming. The special tax rules available to farmers have been utilized by both full-time farmers and by high-bracket taxpayers who participated in farming as a sideline. Part-time farmers have been entitled to use the special farm rules even if they were absentee owners who paid agents to operate their farming activities and regarded their own participation (such as being limited partners in a nationwide syndicate) as a completely passive investment.

Taxpayers engaged in farming have been allowed to report their income and expenses from farm operations on the cash method of accounting, which does not require the accumulation of inventory costs. Farmers have also been allowed to deduct the cost of seed and young plants purchased in one year which would be sold as farm products in a later year.[1] These rules contrast with the tax rules applicable to nonfarm taxpayers engaged in the business of selling products, who must report their income using the accrual method of accounting and must accumulate their production costs in inventory until the product is sold.

The special inventory exception for farmers was adopted by administrative regulation more than fifty years ago. The primary justification for this exception was the relative simplicity of the cash method of accounting which, for example, eliminates the need to identify specific costs incurred in raising particular animals.

The Treasury has also long permitted farmers to deduct currently many of the costs of raising or growing farm assets (such as costs related to breeding animals, orchards and vineyards) which are used in the trade or business of farming.[2] (In similar nonfarming businesses, such as manufacturing, these costs generally are treated as capital expenditures and are depreciated over their useful lives.) These assets

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[14] Increases in basis occuring after December 31, 1975, as a result of income from the discharge of indebtedness attributable to property used in an activity with respect to which substantial deductions were taken in taxable years beginning before January 1, 1976, are not to increase a taxpayer's at risk amount with respect to that activity.

[1] However, a farmer has not been allowed to deduct the purchase price of livestock, such as cattle, which he intended to fatten for sale as beef.

[2] Not all costs relating to development of farm assets have been currently deductible. A farmer has been required to capitalize costs of water wells, irrigation pipes and ditches, reservoirs, dams, roads, trucks, farm machinery, land and buildings.

Thus, even prior to the changes made by the Act, section 278 of prior law specifically required capitalization of all amounts attributable to the planting, cultivating, maintaining or developing of an almond or citrus grove during the first four years after the grove was planted.

are used in a taxpayer's business and may eventually be sold at a gain which is taxed at the lower capital gain tax rate. Since development costs could be deducted before the income is realized from the sale of livestock or crops, the development costs would offset a farm investor's income from other sources such as salaries, interest, professional fees, etc.

Certain other statutory provisions allow specific types of capital improvements to farmland to be deducted when the taxpayer pays them. These costs include soil or water conservation expenditures (sec. 175), fertilizer costs (sec. 180), and land clearing expenses (sec. 182). Similar capital expenditures in a nonfarm business would be added to the basis of the property and, since land is nondepreciable, could be recovered only out of the proceeds when the land is sold.

Capital gain treatment is generally available on the sale of depreciable assets used in farming (as well as on the sale of the underlying farmland itself), even though these assets or land may have been developed or improved by expenditures which were deducted against ordinary income.[3] In effect, a farm investor's income which has been initially sheltered by accelerated farm deductions has been transformed into added capital value of the farm asset and taxed as part of that value when the farm capital assets (vineyard, breeding animal, farmland, etc.) are later sold.

After breeding animals, vineyards or orchards reach maturity and are held for the production of annual crops, farmers and farm investors continue to receive tax benefits through deductions for accelerated depreciation.[4]

Capital gain treatment on the sale of farm asests held for the production of income or used in a taxpayer's farm business is not available to the extent that various recapture rules of present law are applicable. For example, section 1251 requires a limited recapture as ordinary income (rather than capital gain) of previous farm tax losses whenever assets used in a farming business are sold or disposed of. (This section of prior law was amended by section 206 of the Act.)

Section 1252 recaptures amounts previously deducted as soil and water conservation and land clearing expenses if farmland is sold within 5 years after acquisition. If the land is held for a longer period, the amount recaptured is reduced by 20 percent for each year over 5 years that the property is held. Thus, if the land is held more than 10 years, no recapture is required on a sale of farmland.

The holding period for long-term capital gain treatment of cattle and horses held for draft, breeding, dairy, or sporting purposes (such as horse racing) is 24 months (sec. 1231(b)(3)). The minimum hold-

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[3] Under section 1231, a taxpayer who sells property used in his trade or business obtains a special tax treatment. All gains and losses from section 1231 property are aggregated for each taxable year and the gain, if any, is treated as capital gain. The loss, if any, is treated as an ordinary loss. Machinery, equipment, buildings and land used by a taxpayer in his business are examples of section 1231 property.

[4] For example, an investor or rancher can use 200 percent declining balance depreciation on the purchase price of breeding animals which he originally purchased for the herd. If the rancher purchased cattle which had been used for breeding by a previous owner, the cattle can be depreciated on the 150 percent declining balance method.

The offspring of purchased animals cannot be depreciated, however, since the owner is considered to have no cost basis in such animals. (As indicated earlier, however, the cost of raising such offspring can be expensed.)

Accelerated depreciation under a 150-percent declining balance method is also available for new farm buildings and for the costs of purchased vineyards and orchards. The capitalized costs of vineyards and orchards planted by the taxpayer may be depreciated on a 200-percent declining balance method.

ing period for other livestock held for such purposes is 12 months. (One effect of this rule is that many sales of "culls" from a breeding herd, i.e., animals regarded as unsuitable, are taxable at ordinary income rates, since many culls are sold within 24 months.)[5]

Section 183 limits the current deduction of expenses in an activity which a taxpayer conducts other than "for profit." Although not limited to farming, this provision may affect a variety of farm operations. If an activity is found not to be engaged in for profit, expenses can be deducted only to the extent that income derived from the activity exceeds deductible interest, taxes and casualty losses.

Reasons for change

Farm investments have offered an opportunity to defer taxes on nonfarm income where investors were able to take advantage of the special farm tax rules to deduct farm expenses in a year or years prior to the years when the revenue associated with such expenses was earned. This type of deferral could occur regardless of whether the proceeds from the later sale of the underlying products were taxed at ordinary income or capital gain rates. Generally, in farming operations tax losses were shown in early years of an investment because of (1) the opportunity to deduct, when paid, costs which in nonfarm businesses would be inventoried and deducted in a later year, (2) the ability to deduct, when paid, costs which under general accounting principles should have been capitalized, and (3) the ability to claim depreciation deductions which exceeded straight-line depreciation.

These tax losses were used to offset income from a taxpayer's other nonfarm occupations or investments on which he would otherwise have been required to pay tax currently. When the income which was related to these deductions was reported, it was not reduced by the amount of the deductions attributable to it (and was thus greater in net amount than it otherwise would be). This lack of matching resulted in deferral of taxes from the years when the initial deductions were taken. If the related farm income was eventually realized as capital gain (as it might have been where breeding animals or orchards were sold), conversion of ordinary income (against which the expenses were deducted) into capital gain also resulted. Even without the possibility of conversion, however, the tax advantages of deferral alone were frequently sufficient to motivate high-income taxpayers to engage in certain types of farming activities.

Even after the Tax Reform Act of 1969, high-bracket taxpayers continued to use farm tax rules to shelter nonfarm income because (except for citrus and almond groves) the restrictions in prior law did not prevent the initial deferral of taxes on nonfarm income by means of accelerated deductions incurred in farm activities. Prior law focused largely on recapturing deductions which otherwise would be used to convert ordinary income into capital gain, and on limiting capital gain treatment by increasing the holding periods for farm assets. However, under the cash method of accounting, farm expenses

[5] The statute also prevents tax-free exchanges of livestock of different sexes (sec. 1031 (e)). Prior to the Tax Reform Act of 1969, such exchanges had been used to enable a rancher (or ranch investor) to build up his herd free of current tax by exchanging bull calves, most of which are not used for breeding purposes, for female calves which could be used to increase the size of the herd.

are still deductible as they are paid. The time value of deferring taxes on nonfarm income remained a strong attraction for outside investors to invest in farming and to use as much borrowed money as possible to create farm "tax losses."

Since 1969, the number and volume of publicly syndicated investments in almost all areas of agriculture increased substantially. Farm tax benefits were effectively packaged and sold to high-bracket taxpayers through limited partnerships (and management contracts) for investments in cattle feeding and breeding, tree crops, vegetable and other field crops, vineyards, dairy cows, fish, chickens, and egg production.

Table 1 sets forth the average farm loss reported for tax purposes since 1969 by individual taxpayers in different income brackets. This table shows that average farm losses increased as taxpayers' income levels increased, and that this trend remained consistent during the four years covered by the table. The fact that the largest farm losses were concentrated in income levels over $100,000 suggests that high-bracket taxpayers continued to make use of the special farm tax rules to shelter their nonfarm income.

TABLE 1.—NET FARM LOSSES BY SIZE OF ADJUSTED GROSS INCOME

	1970		1971	
Adjusted gross income	Returns showing farm loss	Average farm loss	Returns showing farm loss	Average farm loss
All returns—total	1, 234, 092	($2, 350)	1, 290, 203	($2, 540)
Total net farm loss (thousands)		(2, 899, 513)		(3, 277, 548)
Under $5,000	485, 531	(2, 659)	475, 983	(2, 969)
$5,000 under $10,000	379, 947	(1, 576)	385, 338	(1, 664)
$10,000 under $20,000	284, 652	(1, 669)	327, 808	(1, 822)
$20,000 under $50,000	63, 949	(4, 202)	78, 358	(4, 087)
$50,000 under $100,000	14, 697	(9, 473)	16, 575	(9, 527)
$100,000 under $500,000	5, 012	(21, 016)	5, 787	(20, 903)
$500,000 under $1,000,000	210	(43, 143)	252	(52, 516)
$1,000,000 or more	94	(128, 149)	102	(134, 069)
	1972		**1973**	
Adjusted gross income	Returns showing farm loss	Average farm loss	Returns showing farm loss	Average farm loss
All returns—total	1, 171, 591	($2, 758)	1, 218, 962	($3, 343)
Total net farm loss (thousands)		(3, 230, 956)		(4, 074, 998)
Under $5,000	363, 492	(3, 821)	371, 489	(4, 323)
$5,000 under $10,000	325, 492	(1, 879)	290, 056	(2, 365)
$10,000 under $20,000	354, 754	(1, 852)	397, 588	(2, 123)
$20,000 under $50,000	100, 840	(3, 894)	126, 567	(3, 907)
$50,000 under $100,000	19, 642	(9, 607)	24, 494	(8, 970)
$100,000 under $500,000	6, 941	(21, 784)	8, 390	(23, 108)
$500,000 under $1,000,000	301	(50, 296)	268	(70, 451)
$1,000,000 or more	129	(170, 418)	110	(110, 018)

Source: U.S. Treasury Department, Statistics of Income—Individual Income Tax Returns, 1970, 1971, 1972, 1973 (preliminary).

Deferral shelters.—Some of the more popular types of farming operations which have been used as deferral shelters are set out below.

Cattle feeding has offered one of the best known and, until recent downturns in the farm economy, most widely used deferral shelters. Typically, the investment has been organized as a limited partnership or as an agency relationship (under a management contract) in which a commercial feedlot or a promoter has agreed to act as an agent for the investor in buying, feeding and managing cattle. After being fed a specialized diet for four to six months, the fattened cattle were sold at public auction to meat packers or food companies. A cattle feeding venture of this kind has typically been formed in November or December, using leveraging and the cash method of accounting to permit taxpayers with income from other sources to defer taxes otherwise due on that income in that year by deducting expenses for prepaid feed, interest, and other costs incurred in the feeding venture. Income was realized in the following year when the fattened cattle were sold. At that time, the bank loans were repaid and any unpaid fees due the feedlot (or promoter) were deducted. The balance was distributed to the investors. Since feeder cattle are held for sale to customers, sales of the animals produce ordinary income. If the investors were to reinvest their profit from one feeding cycle into another one, they could theoretically defer taxes indefinitely on the nonfarm income which they sheltered originally.

Since most investors in cattle feeding shelters have typically bought in at the end of the calendar year, deductions for prepaid feed for the cattle have been central to the creation of tax losses in that year.[6]

Another deferral shelter involved the production and sale of eggs. In egg shelters, almost the entire amount invested and borrowed was spent on items for which deductions were claimed in the first year. These items included poultry flocks, prepaid feed, and (to some extent) management fees to the persons who operated the program for the investors. Under prior law, amounts paid for egg-laying hens, which are commonly kept for one year from the time they start producing, have been treated as allowable deductions in the year the poultry was purchased.[7]

Deferral and conversion shelters.—A deferral and conversion shelter has offered an investor an opportunity both to defer taxes and also to convert ordinary income into capital gain. The manner in which these benefits were obtained was by deducting development costs of section 1231 property (breeding cattle, orchards, vineyards, etc.) and capital gain property (farmland) from ordinary nonfarm income and by later selling the developed assets after the investor had held them long enough to qualify for long-term capital gain rates. Since the recapture rules which apply to deducted development expenses (e.g., section 1251) are much more limited in scope than depreciation recapture rules generally, many farm operations can be structured so that there will be little or no recapture of previously deducted development costs.

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[6] In recent years, the Internal Revenue Service questioned deductions for prepaid feed claimed by taxpayers using the cash method of accounting. The Service (in Rev. Rul. 75–152) prescribed several technical criteria and relied on its general authority to recompute a taxpayer's income if deductions materially distort his income. However, investors in cattle feeding shelters, in some cases, had still been able to circumvent the administrative criteria in order to justify deductions for prepaid feed.

[7] Rev. Rul. 60–191, 1960–1 C.B. 78. The purchase cost of this poultry may be deducted currently if the farmer consistently does so and if the deductions clearly reflect his income.

Livestock breeding has offered taxpayers the opportunity to defer taxes over a period of two or more years and also to convert ordinary income into capital gain. In general, breeding operations have relied on current deductions for prepaid expense items; current deductions for expenses of raising young animals to be used for breeding, dairy, draft or sporting purposes; the investment credit; accelerated depreciation and additional first-year depreciation on purchased animals and equipment; and capital gain when the mature animals are eventually sold.

Although cattle has been the most widely used breeding shelter, there have also been investments offered for the purchase, breeding and sale of horses, fur-bearing animals (such as mink and chinchilla), other types of farm animals (such as hogs), and some kinds of fish and shellfish.

An investment in an orchard, vineyard or grove involves a "tree crop" as distinct from a "field" crop such as vegetables. The list of tree crop partnerships has covered virtually anything grown in an orchard or vineyard in the form of trees or vines which produce annual crops of fruits (e.g., grapes, apples or avocados) or nuts (e.g., pecans, pistachios or walnuts).[8]

During the development period of trees or vines, the owners have deducted costs of spraying, fertilizing, irrigating and cultivating the tree or vine to its crop-producing stage. They have also depreciated farm machinery, irrigation equipment, sprinkler systems, wells and fences which they installed on the property. They have also obtained the investment credit; and deductions were often available for interest, fees and some prepaid items. After the trees start producing fruit or nuts, the owner has depreciated the costs of the seedlings and their original planting. (These costs were capitalized when incurred.) Such depreciation has been used partly to shelter the annual crop income. Income from the crop sales is ordinary income. Capital gain is available, however, when the underlying land and the orchard are sold (except to the extent that recapture rules come into play).

Use of farming syndicates.—These special farm tax rules have been utilized not only by taxpayers who were actively engaged in farming enterprises with the intention of making a profit, but also by passive investors whose motivation, in large part, consisted of a desire to use these farming rules to shelter income from other sources. These passive investors were frequently members of "farming syndicates" formed by a promoter or operator. In order to offer attribution of losses and limited liability to the investor, a farming syndicate has generally been structured as either a limited partnership or as an agency relationship with a management contract (and with limited liability generally provided for by nonrecourse indebtedness, insurance, stop-loss guarantees, etc.). During the 5½ years between January 1, 1970, and July 1, 1975, the dollar amount of tax shelter offerings in partnership form registered with the National Association of Securities Dealers was $942,424,000 in cattle feeding and breeding ventures and $166,575,625 in vineyards and other farming shelters. (There have been many more private syndications which were not required to be registered.)

[8] Citrus fruits and almonds were generally not suited to tax shelter because of the cost capitalization rule of section 278.

Congress believed that the special farm tax rules should be continued for most farmers who are actively engaged in farm operations, but that such special farm tax rules should be severely curtailed for farming syndicates in which a substantial portion of the interest is held by taxpayers who are motivated, in very large part, by a desire to shelter other income, rather than by a desire to make a profit in the particular farming operation.

Congress also believed that reducing tax incentives for high-bracket taxpayers who invest in syndicated farming operations will improve the competitive position of full-time farmers who must look to the income generated from farm operations for all or most of the return on their investment in farm operations.

Explanation of provisions

In general, the Act requires farming syndicates to deduct expenses for feed, seed, fertilizer, etc., only when used or consumed, to deduct expenses of purchased poultry only over their useful life (or, in the case of inventory, only when disposed of) and to capitalize certain cultivation, maintenance, etc., expenses of groves, orchards and vineyards to the extent such expenses are incurred before the grove, orchard or vineyard becomes productive.[9]

Definition of farming syndicate.—For purposes of these provisions, a "farming syndicate" is defined as including (1) a partnership [10] or other enterprise (other than a corporation which is not a subchapter S corporation) engaged in farming if, at any time, any interest in the partnership or other enterprise has been offered for sale in an offering required to be registered with a Federal or State agency having authority to regulate the offering of securities for sale, (2) a partnership or other enterprise (other than a corporation which is not a subchapter S corporation) engaged in the trade or business of farming if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.[11]

These categories include as farming syndicates many forms of organization of farm enterprises such as general partnerships, sole proprietorships involving agency relationships created by management contracts, trusts, and interests in subchapter S corporations.[12] If an interest in any such enterprise has been offered for sale in an offering required to be registered, it is a farming syndicate. Similarly, unless excepted by the five specific exceptions described below, if more than

[9] Also, as a general limitation on the use of the farm tax rules, Congress provided that tax losses incurred in farming are to be allowable in any year only to the extent of the amounts for which the taxpayer is at risk in the business. This rule applies to all types of taxpayers engaged in farming operations (sec. 204 of the Act).

[10] The term "partnership" is used in the farming syndicate provisions only in a descriptive sense; it is not intended that this definition of farming syndicate operate to preclude the Internal Revenue Service from applying the regulations under section 7701 to an organization described in such definition to determine its proper classification (as a partnership or corporation) for Federal tax purposes.

[11] Thus, the first category of farming syndicates includes limited partnership and other tax shelter offerings required to be registered with the Securities and Exchange Commission or with a State securities or real estate office. The second category includes partnerships or other enterprises with respect to which there is no registration requirement. Unregistered offerings made through a dealer who is a member of the National Association of Securities Dealers, through an intrastate broker-dealer, or through a real estate company, as well as interests in private enterprises which are not sold by a broker-dealer, or similar party are included in the second category, if the loss allocation requirements are satisfied.

[12] Corporations other than subchapter S corporations are not treated as farming syndicates since tax losses in such corporations cannot be passed through to its shareholders.

35 percent of the losses during any year are allocable to limited partners or limited entrepreneurs, the enterprise will be treated as a farming syndicate.

In general, a limited entrepreneur means a person who has an interest, other than a limited partnership interest, in an enterprise and who does not actively participate in the management of the enterprise. The determination of whether a person actively participates in the operation or management of a farm depends upon the facts and circumstances. Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the farm, actually working on the farm, living on the farm, or hiring and discharging employees (as compared to only the farm manager). Factors which tend to indicate a lack of active participation include lack of control of the management and operation of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, and having limited liability for farm losses.[13]

With respect to farming activities other than those conducted by enterprises in which securities have been registered or were required to be registered, the provision specifies five cases where an individual's activity with respect to a farm will result in his not being treated as a limited partner or limited entrepreneur. These cases cover situations where an individual—

(1) has an interest in a trade or business of farming attributable to his active participation for a period of not less than 5 years in the management of the trade or business of farming[14];

(2) lives on the farm on which the trade or business of farming is being carried on (but only with respect to farming activities on such farm);

(3) actively participates in the management of a trade or business of farming which involves the raising of livestock (or is treated as being engaged in active management pursuant to one of the first two exceptions set forth above), and the trade or business of the partnership or any other enterprise involves the further processing of the livestock raised in the trade or business with respect to which he is (actually or constructively) an active participant;

(4) actively participates, as his principal business activity, in the management of a trade or business of farming, regardless of whether he actively participates in the management of the activity in question; or

(5) is a member of the family (within the meaning of section 267(c)(4)) of a grandparent of an individual who would be ex-

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[13] In determining whether a person has limited liability for farm losses, all the facts and circumstances are to be taken into account. Generally, for purposes of this definition, a person will be considered to have limited liability for farm losses if he is protected against loss to any significant degree by nonrecourse financing, stop-loss orders, guarantees, fixed price repurchase (or purchase) agreements, insurance, or other similar arrangements. A person with limited liability for farm losses might include, in appropriate circumstances, (1) a general partner who has obtained a guaranty or other protection against loss from another general partner or an agent, and (2) a principal who has given authority, in fact, to another party to conduct his operations (such as an investor who agrees to allow a feedlot to manage feeder cattle which he has purchased) and who utilizes nonrecourse financing, stop-loss orders insurance, etc., to limit his risk.

[14] This exception (and the fifth exception to the extent it applies this exception to family members of a person qualifying under this exception) will continue to apply where one farm is substituted for or added to another farm.

cepted under any of the first four cases listed above and his interest is attributable to the active participation of such individual.

The first exception listed above (and its application to family members by the fifth exception) is designed to insure that the term "farming syndicate" does not include an enterprise in which a limited partnership interest (or other passive interest) is held by a person who has actively participated in the management of the enterprise for not less than five years merely by reason of his holding such a limited partnership interest (or other passive interest). Also, a member of the family of such a person, such as one of his heirs, would not be treated as a limited partner or limited entrepreneur for purposes of making the farming enterprise a farming syndicate. Thus, for example, if A, an individual who has owned and operated a farm for more than five years, wishes to retire and forms the AB limited partnership with B, an unrelated individual, and more than 35 percent of the losses are allocated to A, the limited partner, the AB partnership will not be treated as a farming syndicate because A's interest is not treated as a limited partnership interest for purposes of determining whether losses are allocated to limited partners. Similarly, if A later dies and the partnership is continued by B and C, A's son, the BC partnership will not be treated as a farming syndicate.

Definition of farming.—For purposes of these farming syndicate rules, the term "farming" is defined to mean cultivation of land or the raising or harvesting of any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of animals. Thus, for example, a syndicate engaged in the raising of livestock, fish, poultry, bees, dogs, flowers, or vegetables is engaged in farming and, thus, is a farming syndicate.

For purposes of the farming syndicate rules, activities involving the growing or raising of trees (other than fruit or nut trees) are not considering farming. Thus, this provision does not apply to forestry or the growing of timber.

Deduction of prepaid items.—The Act adds a new section (sec. 464(a)) to the Code to provide in general, that, in the case of farming syndicates, deductions for amounts paid for feed, seed, fertilizer, or other similar farm supplies are allowed only in the taxable year in which the feed, seed, fertilizer or other supplies are used or consumed. This provision prevents a farm syndicate from obtaining current deductions for prepaid feed, seed, fertilizer, etc., except in situations where the feed, seed, fertilizer, or other supplies are on hand at the close of the taxable year solely because the consumption of such items during the taxable year was prevented on account of fire, storm, flood, or other casualty, or on account of disease or drought.

Costs of poultry.—Under prior law, taxpayers engaged in farming have not been allowed to deduct the cost of purchased livestock; rather, they must inventory the livestock held for sale and deduct the cost only upon disposition, and they must capitalize the cost of purchased livestock used in the trade or business (such as cattle held for breeding purposes) and depreciate them over their useful lives. However, this has not been the case with respect to poultry. A ruling by the Internal Revenue Service (Rev. Rul. 60–191, 1960–1 C. B. 78) has allowed cash basis taxpayers to deduct when paid the costs of both poultry held for sale and poultry used in the trade or business. These deductions were allowable, in general, because the poultry purchased for resale has a relatively small cost, and the poultry purchased for use in the trade or business, such as laying hens, has a useful life of less than one year. Some syndicates, however, have taken advantage of these rules and, coupled with the prior rules relating to prepaid feed, have utilized the deductions for poultry to create tax shelters.

The Act adds a new Code provision (sec. 464(b)) which does not allow a farming syndicate to deduct when paid costs of acquiring poultry. Rather, it requires that the cost of poultry acquired for resale not be deducted until the poultry is sold or otherwise disposed of. Also, in the case of poultry acquired for use in the trade or business (such as laying hens) or acquired both for use in trade or business and for later resale, the costs must be capitalized and (taking into account salvage value) deducted ratably on a monthly basis over the lesser of twelve months or their useful life in the trade or business.[15]

Capitalization of development costs of groves, orchards, and vineyards.—The Act amends section 278 to provide that, in the case of a farming syndicate, any amount otherwise allowable as a deduction which is attributable to the planting, cultivation, maintenance, or development of a grove, orchard, or vineyard, and which is incurred prior to the taxable year in which the grove, orchard, or vineyard begins to produce crops in commercial quantities is required to be capitalized. Such expenditures can thereafter be recovered by depreciation of the grove, orchard, or vineyard. A limited exception to this capitalization rule is provided for amounts allowable as deductions (without regard to section 278) which are attributable to a grove, orchard, or vineyard, which is replanted after having been lost or damaged while in the hands of the taxpayer by reason of freezing temperatures, disease, drought, pests, or casualty.

Where these new rules apply to a situation in which section 278(a) (relating to capitalization of certain expenses of citrus and almond groves) requires capitalization but for a different period (4 years instead of the preproductive period), the rules of capitalization of section 278(a) apply prior to the capalization rules with respect to farming syndicates. Also, if an amount is incurred as a cost of fertilizer, or other prepaid supplies, which is generally subject to the rules of new section 464(a), such amount is nonetheless subject to the farming syndicate capitalization rules of section 278(b). Thus, in such a case, no deduction would be allowed upon consumption of the fertilizer, but rather such amount would have to be charged to capital account.

Effective dates

The provisions of the Act relating to prepaid feed and other farm supplies and poultry expenses apply generally to amounts paid or incurred in taxable years beginning after December 31, 1975. In the case of farming syndicates in existence on December 31, 1975 (but only if there is no change in membership in the farming syndicate

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[15] Since the only basis for deducting the cost of the laying hens currently was that they have an expected useful life of less than one year, the requirement that deductions be taken over the lesser of 1 year or the useful life should not result in the acceleration of such deductions.

throughout its taxable year beginning in 1976), these provisions apply to amounts paid or incurred in taxable years beginning after December 31, 1976.[16] The provisions relating to orchards, groves and vineyards do not apply where the trees or vines were planted or purchased for planting prior to December 31, 1975, or where there was a binding contract to purchase the trees or vines in effect on December 31, 1975.

Revenue effect

This provision will increase budget receipts by $86 million in fiscal year 1977, $32 million in fiscal year 1978, and $34 million in fiscal year 1981.

b. Limitation of Loss With Respect to Farms to the Amount for Which the Taxpayer Is at Risk (sec. 204 of the Act and sec. 465 of the Code)

Prior law

Generally, the amount of depreciation or other deductions which a taxpayer has been permitted to take in connection with a property has been limited to the amount of his basis in the property. Likewise, in the case of a partnership, the amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership. However, basis in a property has included nonrecourse indebtedness (i.e. a loan on which there is no personal liability) attributable to that property. Where a partnership incurs a debt obligation, and none of the partners has personal liability on the loan, all of the partners have been treated for tax purposes as though they shared the liability in proportion to their profits interest in the partnership (i.e. each partner's share in the nonrecourse indebtedness is added to his basis in the partnership). (See regulations § 1.752–1(e)).

Also, there has been generally no limitation on deductions which take into account a taxpayer's protection against ultimate loss by reason of a stop-loss order, guarantee, guaranteed repurchase agreement, insurance or otherwise.

Reasons for change

Taxpayers have combined the special farm tax rules (discussed under the farm syndicate section above) with nonrecourse indebtedness, and stop-loss orders, etc., to deduct losses in a taxable year which are substantially in excess of the maximum amounts they could ultimately lose with respect to their investments in farming. Although some of these situations may be limited by the restrictions on deductions imposed on syndicates (as described above), some farming shelters may not involve syndicates. Also, the limitations on syndicates do not affect all types of farming operations. For instance, winter vegetables, rose bushes and other nursery plants are not restricted by the restrictions on farming syndicates, except to the extent that such syndicates utilize prepaid seed, fertilizer, and other farm supplies. (The utilization of such prepaid items is not necessary for the creation of substantial tax shelter in these types of operations.)

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[16] A change in membership which disqualifies a farming syndicate from this transitional rule does not include substitutions occurring by operation of law, gifts, or withdrawals by existing members.

Explanation of provisions

To prevent a situation where a taxpayer may deduct a loss in excess of his economic investment in farming operations, the Act provides that the amount of any loss (otherwise allowable for the year) which may be deducted in connection with a trade or business of farming, cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. (For more detail as to the application and scope of the at risk rule, see section 2, above.)

In applying the at risk provision to farming operations,[17] Congress intends that the existence of a governmental target price program (such as provided by the Agriculture and Consumer Protection Act of 1973) or other governmental price support program with respect to a product grown by a taxpayer does not, in the absence of agreements limiting the taxpayer's costs, reduce the amount which such taxpayer is at risk.

In the case of farming activities carried on by an individual, the "at risk" provision applies separately to each farming activity. Whether a taxpayer is engaged in one or more farming activities depends on all the facts and circumstances of the case. Generally, some of the significant facts and circumstances in making a determination are the degree of organizational and economic interrelationship of various activities in which the taxpayer is engaged, the business purpose which is (or might be) served by carrying on the various activities separately or together, and the similarity of the various activities. Thus, for instance, if a rancher engaged in cattle raising on his own ranch also purchases cattle which he has placed in a commercial feedlot, he will generally be treated as being in two separate farming activities. However, if such a rancher were, as a consistent business practice, to take cattle raised on his own ranch and place them in a commercial feedlot, he might well be treated as engaged in only one farming activity.

All farming activities engaged in by a partnership or subchapter S corporation will be treated as one activity for purposes of applying this provision.[18]

Effective date

In the case of farm operations, the at risk limitation applies to losses attributable to amounts paid or incurred in taxable years beginning after December 31, 1975.

Revenue estimate

It is estimated that this provision will result in an increase in budget receipts of less than $5 million annually.

c. Method of Accounting for Corporations Engaged in Farming (sec. 207(c) of the Act and new sec. 447 of the Code)

Prior law

Under prior law, a taxpayer engaged in farming activities was allowed to report the results of such activities for tax purposes on the

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[17] For purposes of the at risk provision, the term "farming" has the same meaning as it does in the farming syndicate provisions discussed above.

[18] This aggregation approach is adopted because of the difficulties of allocating a partner's at risk amount between different activities.

cash method of accounting, regardless of whether the taxpayer was an individual, a corporation, a trust, or an estate. As indicated in the discussion of the farming syndicate rules, the availability of the cash method for farmers has contrasted with the tax rules which govern nonfarm taxpayers engaged in the business of selling products. Such nonfarm taxpayers must report their income using the accrual method of accounting and must accumulate their production costs in inventory until the product is sold.[19] Under the accrual method of accounting as applied to farming, if crops are harvested and unsold at the end of the taxable year, the costs attributable to such crops cannot be deducted in the taxable year but must be treated as inventory. However, even under the accrual method, it has been a longstanding Treasury practice to permit a farmer to deduct expenses paid in the taxable year so long as the crops to which these expenses relate are unharvested at the end of the taxable year. (I.T. 1368, I–1 C.B. 72(1922).)

The Internal Revenue Service has recently ruled that, for taxable years beginning on or after June 28, 1976, an accrual method taxpayer engaged in farming is required to inventory growing crops (unless the taxpayer uses the crop method of accounting).[20]

Furthermore, except with respect to citrus and almond groves, a taxpayer engaged in farming has generally been allowed to deduct currently costs of developing certain assets used in the trade or business of farming (such as cultivation expenses of orchards and groves) even if an accrual method of accounting was used; however, taxpayers in other businesses are generally required to capitalize the costs of constructing or developing assets used in the trade or business.[21]

Reasons for change

Under the cash method of accounting, all items which constitute gross income are reported in the taxable year in which actually or constructively received, and expenses are deducted in the taxable years in which they are actually paid. The primary advantage of the cash method is that it generally requires a minimum of recordkeeping; however, it frequently does not match income with related expenses. Consequently, the cash method can be used to create tax losses which defer current tax liabilities on both farm and nonfarm income. Corporations, as well as individuals, can benefit by the time value of such deferral of taxes.

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[19] A primary goal of the accrual method of accounting is a matching of income and expenses. Under this method, income is included for the taxable year when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to the expense and the amount can be determined with reasonable accuracy. Also, under the accrual method, where the manufacture or purchase of items which are to be sold is an income-producing factor, inventories must be kept and the costs of the merchandise must be accumulated in inventory (rather than deducted when incurred). These costs may be deducted only in the year the merchandise is sold. Regs. § 1.446–1(a)(4) and (c).

[20] Rev. Rul. 76–242, 1976–26 I.R.B. 9. This ruling also specifically requires an accrual method taxpayer operating a nursery to inventory growing trees and an accrual method florist to inventory growing plants (unless the taxpayer uses the crop method of accounting).

Under the crop method of accounting, where a farmer is engaged in producing crops and the process of gatherings and disposal of the crops is not completed in the taxable year in which the crops were planted, expenses of producing, gathering and disposing of the crop are taken only in the taxable year in which the gross income from the crop is realized. Regs. § 1.162–12(a).

[21] See, *e.g.*, *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974).

The opportunity for farmers generally to use the cash method of accounting, without inventories and with current deduction of certain expenses which are properly capitalizable, was granted over 50 years ago by administrative rulings. These rulings were issued at a time when most agricultural operations were small operations carried on by individuals. The primary justification for the cash method of accounting for farm operations was its relative simplicity which, for example, eliminates the need to identify specific costs incurred in raising particular crops or animals.

In recent years, however, many corporations have entered farming. While some of these corporations involve relatively small business operations owned by a family or a few individuals, other corporations conduct large farm businesses which have ready access to the skilled accounting assistance often required to identify specific farm costs. In addition, sophisticated farm operations have often been carried on by farm syndicates or partnerships consisting of high-income investors and a corporation representing a promoter of a farm "tax shelter."

In view of this, Congress believed it was appropriate to require that certain corporations, and certain partnerships, engaged in farming to this requirement small or family corporations in order to continue the cash basis method of accounting essentially for all those but the larger corporations engaged in farming.[22]

Explanation of provisions

In general.—The Act adds a new provision to the Code (sec. 447) which requires that corporations (other than nurseries, certain "family owned" corporations, subchapter S corporations, and certain corporations with annual gross receipts of less than $1,000,000) and certain partnerships to use the accrual method of accounting for farm operations and also to capitalize their preproductive period expenses of growing or raising crops or animals.

For purposes of this provision, farming is intended to be defined in the same manner as it is defined in the farming syndicate rules.[23] Since under this provision, a corporation engaged in forestry or the growing of timber is not thereby engaged in the business of farming,[24] this provision does not affect the method of accounting (or treatment of preproductive period expenses) of corporations engaged in forestry or the growing of timber.

Certain excepted corporations.—The Act provides a series of exceptions to the rule that farming corporations must use the accrual accounting method. One exception to the required accrual accounting rules is provided for nurseries. Thus, a corporation which is engaged

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[22] Since the new rules for corporations engaged in farming do not apply to subchapter S corporations, any corporation eligible to elect subchapter S status may so elect and thus be exempt from being required to use the accrual method of accounting.

[23] For purposes of this provision, income derived from the personal services of employees who are engaged in the operation of machinery used in connection with farming activities of other taxpayers is not income from the trade or business of farming. Consequently, unless otherwise required by prior law, a corporation will not be required to compute taxable income from such activities on an accrual method of accounting. For example, if a corporation owns a combine and trucks which are operated by its employees in contract harvesting operations, the taxable income of such corporation need not be computed on an accrual method of accounting, unless otherwise required.

[24] This exclusion of forestry or the growing of timber from "farming" is consistent with the distinction drawn in regulations relating to provisions of the Code allowing taxpayers engaged in the trade or business of farming to deduct currently expenditures for soil or water conservation, fertilizer for land used in farming, and land clearing (secs. 175, 180, 182 and Regs. §§ 1.175–3, 1.180–1(b), and 1.182–2).

in the business of operating a nursery will not be required to utilize the accrual method of accounting by reason of this provision of the Act. No inference is intended, however, with respect to any business operation which is required to utilize the accrual method of accounting under provisions of prior law.

Subchapter S corporations, which by definition can have no more than 15 shareholders, and certain family owned corporations are also excepted from the requirement of accrual accounting. A shareholder of a subchapter S corporation, however, is to be subject to the at risk provisions of the Act, and the corporation itself may also be farming syndicate.

A family corporation (excerpted from the requirements of section 447) includes a corporation in which at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and at least 50 percent of the total number of shares of all other classes of stock, are owned by members of the same family. For purposes of this provision, the members of a family are an individual, his brothers and sisters, the brothers and sisters of such individual's parents and grandparents, ancestors and lineal descendants of any of the above, a spouse of any of the above, and the estate of any of these individuals. Ownership of stock by a trust or partnership is to be proportionately attributed to its beneficiaries or partners, as the case may be. [25] Also, stock ownership is to be attributed proportionately through a corporate shareholder (in a farm corporation) to the owners of the corporate shareholder if 50 percent or more in value of the corporate shareholder is owned by members of the same family.[26] In applying these rules, individuals related by the half-blood or by legal adoption are treated as if they were related by the whole blood.

Since a principal justification for use of the cash method of accounting in agriculture is that small enterprises should not be required to keep books and records on the accrual method of accounting, a fourth exception to required accrual accounting covers small corporations. The provision exempts any corporation whose gross receipts (when combined with the gross receipts of related corporations) do not exceed $1,000,000 per year. However, once this level of receipts is exceeded for a taxable year beginning after December 31, 1975, the corporation must change to the accrual method of accounting for subsequent taxable years and may not change back to the cash method of accounting for subsequent taxable years even if its receipts subsequently fall below $1,000,000.[27]

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[25] In determining family ownership under this provision, Congress believes that, if the trustee of a trust has discretion to distribute income or principal to family members or charities and if the trustee has made no distributions (or taken deductions for set-asides) to charities, family beneficiaries should be treated as the sole beneficiaries of the trust. However, Congress does not intend that such beneficiaries should be treated as the sole beneficiaries of the trust for other purposes by reason of the preceding sentence.

[26] Also, if a farming corporation is a wholly-owned subsidiary of another corporation (the "parent corporation"), stock of the subsidiary may be attributed from the parent corporation to another corporation (the "grandparent corporation") and through such grandparent corporation to its shareholders, if 50 percent or more in value of the stock of the grandparent corporation is owned, directly or through a trust or partnership, by members of the same family.

[27] Amounts received from the sale of farmland and improvements, farm machinery and equipment would not be included in "gross receipts" under this provision. With respect to its farming activities, a taxpayer would include only the receipts received from the sale of farm products including livestock held for breeding, draft, dairy or sporting purposes—unless the sale of livestock is not in the ordinary course of business and involves the disposition of a substantial portion of the taxpayer's livestock. In the case of nonfarm items, the taxpayer would include receipts from those items which produce ordinary income as contrasted with those which produce capital gains.

Application to partnerships.—Under this provision, a partnership is also required to use an accrual method (and to capitalize preproductive period expenses) if a corporation is a member of a partnership and the corporation itself would be required under this provision to use the accrual method for its farm operations. (Without a rule of this kind, a corporation directly engaged in farming could escape the general rule of this provision by becoming a partner in a partnership which could still elect the cash method of accounting for the benefit of its partners.) Where the rules of this provision apply to a partnership, noncorporate partners will be affected by the accounting method required to be used by the partnership.[28]

Preproductive period expenses.—The term "preproductive period expenses" (required to be capitalized under this section) means, in general, any expenses which are attributable to crops, animals, trees, or to other property having a crop or yield, during the preproductive period of such property and which are allowable as deductions for the taxable year but for the application of this provision (and the farming syndicate rules, if applicable).[29]

In the case of property having a useful life of more than one year, which will have more than one crop—such as an orchard or vineyard—the preproductive period extends until the disposition of the first marketable crop or yield. Thus, costs attributable to the cultivation, maintenance or development of an orchard or vineyard in a taxable year before the first year in which a marketable crop or yield is sold (and which are currently deductible under prior law) are preproductive period expenses.[30]

In the case of other farm property, such as annual crops (and animals with useful lives of less than one year), the preproductive period includes the entire period before the crop (or animal) is disposed of. For example, amounts paid for laying hens with a useful life of less than one year are "preproductive period expenses" if the hens are purchased in one year and sold in the following year. Similarly, in the case of winter vegetables which are planted in December of one year and harvested in January or February of the following year, a calendar year taxpayer would treat the cost of seeds, planting, cultivating, etc., of the vegetables in December as preproductive period expenses which must be capitalized and deducted only when the crop is sold.

The term "preproductive period expenses" does not include taxes and interest, and also does not include any amount incurred on account

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[28] A partnership with a corporate general partner may be required to use the accrual method of accounting and may also be a farming syndicate subject to limitations on deductible expenses for prepaid feed and other farm supplies, expenses for poultry, and certain expenses of orchards, groves and vineyards. However, feed and other farm supplies are required to be inventoried under the accrual method of accounting, and the expenses (of poultry, orchards, groves and vineyards) that must be capitalized under the farming syndicate rules are also capitalizable preproductive period expenses under the accrual method of accounting (as required by this provision). Consequently, the application of both provisions is not inconsistent; the farming syndicate rules do not appear to impose any additional requirements for an organization subject to this provision.

[29] Soil and water conservation expenditures, as defined in section 175, and land-clearing expenditures, as defined in section 182, are preproductive period expenses if they are incurred in a preproductive period of an agricultural or horticultural activity and if the taxpayer elects to deduct these expenditures rather than capitalize them.

[30] This provision applies to preproductive period expenses of a citrus or almond grove even though under section 278 of the Code, all preproductive expenses of planting, cultivation, maintenance, or development during the first four taxable years beginning with the taxable year in which the tree is planted must be capitalized. The result of this interaction is that, if the preproductive period is greater than four years in any of these cases, the preproductive period expenses in later years will have to be capitalized.

of fire, storm, flood, or other casualty, or on account of disease or drought.

With respect to preproductive expenses, there is a special disposition rule for home-grown supplies. This rule provides that, in the case of deductions which arise because feed is grown on a farm, and is fed to the farmer's chickens, cattle or other animals, the consumption of the feed by the animals transforms the deductions incurred in raising the feed into ordinary deductions in the year the feed is consumed. Such deductions are thus not required to be treated as preproductive period expenses, even though the animals may not be disposed of during that taxable year.

Annual accrual method of accounting.—The Act adds special rules which provide, in general, that, if a corporation (or its predecessors) has, for a 10-year period ending with its first taxable year beginning after December 31, 1975, used an "annual accrual method of accounting" and if the corporation raises crops which are harvested not less than 12 months after planting, the corporation may continue to use this method of accounting for its farming operations. An "annual accrual method of accounting" means a method of accounting under which revenues, costs, and expenses are computed on an accrual method of accounting and the preproductive period expenses incurred during the taxable year are either charged to crops harvested during that year or are currently deducted. To qualify to continue to use this method of accounting, substantially all of the crops grown by the corporation must be harvested not less than 12 months after planting. Also, the corporation (and its predecessors) must have used this method of accounting for at least 10 years. In order for a corporation to utilize the period another corporation has used the annual accrual method, the first corporation must have acquired the assets of a farming trade or business from the second corporation in a transaction in which no gain or loss was recognized to the transferor or transferee corporation.

In general, this 10-year requirement is designed to insure that the method can not be used by new or growing taxpayers to achieve substantial future deferrals, while permitting taxpayers who have had a substantial history of use of this method to continue its use.

If a corporation has used an annual accrual method of accounting together with a static value method of accounting for deferred costs of growing crops for a 10-year period prior to the first year to which these new provisions apply, it may elect to change to the annual accrual method of accounting without the static value method of accounting for deferred costs.

Period for taking adjustments into account.—A taxpayer who is required to change to the accrual method of accounting (or to revise his accrual method of accounting to capitalize preproductive period expenses) pursuant to this provision will be allowed to spread the accounting adjustments required by this method over a period of 10 years unless the Secretary of the Treasury by regulations prescribes different periods in certain types of cases. The corporation will also be treated as having made the change with the consent of the Secretary of the Treasury. Such a change will be treated as not having been initiated by the taxpayer (for purposes of the rule which prohibits adjustments resulting from changes in a taxpayer's method of accounting if the taxpayer initiates the change (sec. 481(a)).

The provision which states that the Secretary of the Treasury may prescribe regulations setting forth exceptions to the general rule that a corporation (or partnership) may spread the adjustments required by the change of accounting method over a 10-year period, is, in general, intended to give the Internal Revenue Service discretion to set forth standards as to when a different period for taking the adjustments into account would be appropriate.[31]

Effective Date

This provision will apply to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of $8 million in fiscal 1977 and $18 million annually thereafter.

d. Termination of Additions to Excess Deductions Accounts Under Sec. 1251 (sec. 206 of the Act and sec. 1251 of the Code)

Prior law

Under prior law (sec. 1251), individuals who reported their farm operations on the cash method of accounting, and who have more than $50,000 of nonfarm adjusted gross income during a year, have been required to maintain an "excess deductions account" (EDA) for a net farm loss sustained in the same year to the extent the loss exceeds $25,000. (It is immaterial what specific farm deductions produced the farm loss.) The EDA account is a cumulative account adjusted from year to year take into account net farm income or loss. For the most part, when the farm assets used in the taxpayer's business (except depreciable real property) are sold or otherwise disposed of, the portion of the gain on the sale or other disposition equal to the balance in the excess deductions account must be reported as ordinary income, rather than capital gain. Any gain recaptured in this manner is then subtracted from the balance in the EDA account as of the end of the same taxable year.[32]

In the case of dispositions of farm land, another provision (sec. 1252) requires recapture of deductions allowed for soil and water conservation expenditures (sec. 175) and for land clearing expenditures (sec. 182) on a gradually reducing scale depending on how long the land is held. However, if recapture is required as a result of an EDA account, this recapture is to occur in the case of a gain or disposition even though the property is subject to a lesser recapture as a result of prior soil and water expenditures or prior land clearing expenditures.

Under prior law, if a corporation had a balance in an EDA account, an otherwise tax free reorganization in which farm recapture property was transferred to another corporation in exchange for its stock and the stock was then distributed would result in EDA recapture unless

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[31] It is contemplated that the Internal Revenue Service might, for example, believe that a shorter period would be appropriate where the taxpayer has been in existence fewer than 10 years prior to the year of change or where the taxpayer is a partnership with a limited life which, as of the year of change, is less than 10 additional years.

[32] Corporations (other than subchapter S corporations) and trusts have been required to establish an EDA account for the full amount of their farm losses regardless of size and regardless of the amount of their nonfarm income. A subchapter S corporation has been governed by the same dollar limitations that apply to individuals, except that the corporation has been required to include in its nonfarm income the largest amount of nonfarm income of any of its shareholders.

substantially all of the assets of the first corporation were transferred to the second corporation.

Reasons for change

Prior law allowed a farm investor who used the cash method of accounting to defer current taxes on his nonfarm income. It merely placed a potential limit on the amount of ordinary nonfarm income which might be converted to capital gain in a future year. Thus, even where an EDA account was required to be maintained, this provision reduced the conversion of ordinary income into capital gain but did not affect the time value of deferring taxes on nonfarm income or on annual farm crop income.

The experience with this provision since it was enacted in 1969 also suggested that the dollar floors which must be reached before farm losses were subject to recapture are quite high, and that the application of the provision was very limited. Treasury statistics of income since 1969 show that the number of tax returns which show nonfarm income of $50,000 and higher and a net farm loss of $25,000 or more has generally been less than one percent of all returns which report both nonfarm income and farm losses. Treasury statistics also show that the provision affects no more than 8 percent of the dollar amount of all farm losses reported on returns which show both nonfarm income and farm losses. Furthermore, it appears that the provision is difficult to apply and susceptible of varying interpretations.

Congress concluded that an approach which focused solely on preventing conversion of ordinary nonfarm income to capital gain, without limiting the initial deferral of current taxes on nonfarm income, did not deal effectively with the use of farm tax rules by high income taxpayers to "shelter" nonfarm income, particularly in some of the more flagrant abuses of the farm tax rules in publicly syndicated farm tax shelters which have been carefully structured to avoid or minimize the effects of section 1251.

Since the new provisions limiting the deductions in the case of farm syndicates, providing an at risk limitation for farm operations, and requiring certain corporations to use the accrual method of accounting, will prevent the deferral of taxes on nonfarm income in many cases, Congress did not believe that it was desirable to continue a complex rule of limited applicability in the statute which recaptures income previously offset by certain farm losses.

Also, Congress believed that it was inappropriate for EDA recapture to be triggered by a divisive "D" reorganization so long as the amounts in the EDA account would remain subject to recapture (under rules which are at least as stringent as if the reorganization had not occurred) when farm recapture property is disposed of by a corporation which survived the reorganization.

Explanation of provision

The Act limits the future applicability of the EDA provision (sec. 1251) by providing that no additions to an excess deductions account need be made for net farm losses sustained in any taxable year beginning after December 31, 1975. Farm losses incurred during any such taxable year or years will instead be governed by other limitations under the Act.

If property which is "farm recapture property" (within the meaning of section 1251(e)(1)) is disposed of during a taxable year beginning after December 31, 1975, however, the recapture rules of present law will continue to apply, but only with respect to EDA accounts required to be maintained for one or more years beginning before December 31, 1975.

The Act allows divisive "D" reorganizations without triggering EDA recapture. In these reorganizations, the entire EDA account is applied to both the transferor corporation and the transferee corporation.

Effective date

The amendments to section 1251 will not affect any recapture of farm losses by reason of a disposition of farm recapture property during a taxable year beginning on or before December 31, 1975.

In the case of dispositions of farm land, the termination of the provision described here for farm losses incurred in taxable years beginning after December 31, 1975, will mean that deductions taken under sections 175 and 182 in years beginning after December 31, 1975, will continue to be subject to recapture, but only to the extent required by section 1252. In such cases, section 1251 will cease to apply to any deductions under sections 175 and 182.

The provisions relating to "D" reorganizations apply to reorganizations occurring after December 31, 1975.

Revenue estimate

It is estimated that these provisions will result in a decrease in tax liability of less than $5 million annually.

e. Scope of Waiver of Statute of Limitations in Case of Activities Not Engaged in for Profit (sec. 214 of the Act and sec. 183(e) of the Code)

Prior law

The tax law distinguishes between activities engaged in "for profit" and activities which are not engaged in for profit (sec. 183). In the case of an activity engaged in for profit, a taxpayer may deduct all expenses attributable to the activity even though they exceed the income from the activity. In the case of an activity not engaged in for profit, a taxpayer can deduct the allowable expenses attributable to the activity only to the extent that income derived from the activity exceeds amounts allowable for interest, taxes and casualty losses attributable to the activity. A taxpayer thus cannot utilize an operating loss incurred in an activity of this kind to offset his other income. Activities which raise issues of this kind include horse breeding, cattle breeding, the racing or showing of horses, and vacation homes.

In determining whether an activity is engaged in for profit, the facts and circumstances must be examined to determine whether the taxpayer entered the activity and continued it with the objective of making a profit. However, the tax law contains a provision under which an activity is presumed to be engaged in for profit if the activity shows a profit in at least 2 out of 5 consecutive taxable years ending with the taxable year in question. (In the case of raising, breeding, training or showing horses, the requirement is a profit in at least 2 of 7 consecutive years.)

If, at the end of a given year, the taxpayer has not conducted the activity for 5 (or 7) years, a special provision allows the taxpayer to elect to postpone a determination as to whether he can benefit by this presumption until he has conducted the activity for 5 (or 7) years (sec. 183(e)). This election was added to the Code in 1971. The committee reports at that time expressed an intent that a taxpayer who made the election should be required to waive the statute of limitations for the 5 (or 7) year period and for a reasonable time thereafter. The aim was to prevent statute of limitations (3 years, in the usual case) from running on any year in the period. The taxpayer, it was believed, should have time to claim a refund of tax paid by him during the period, and the Internal Revenue Service should also have time to assess any deficiency owned by the taxpayer for any year in the period.

In carrying out this legislative intent, the Service has issued temporary regulations which require a taxpayer who makes an election under section 183(e) to agree to extend the statute of limitations for each taxable year in the 5 (or 7) year period to at least 18 months after the due date of his return for the last year in the period. Such an extension must apply to all potential income tax liabilities arising during the period, including issues unrelated to deductions subject to section 183 issues.

The reason for requiring such a broad waiver stems from a provision under prior law which, in certain circumstances, allows only one notice of deficiency to be sent to a taxpayer with respect to a taxable year. If a taxpayer receives a notice of deficiency and then files a petition with the Tax Court relating to that notice, the Service cannot (as a general rule) determine an additional deficiency for the same taxable year (sec. 6212(c)). Therefore, if, within the present limitations period, the Service sends a deficiency notice to a taxpayer relating to an issue other than section 183 and the taxpayer petitions the Tax Court as to one or more of those issues, the Service cannot later assess a separate deficiency under section 183. In order to prevent such a result, the temporary regulations require the waiver to cover all tax issues during the presumption period and not just the potential section 183 issues.

Reasons for change

The requirement that all items on a taxpayer's returns for the early years of a 5 (or 7) year period be kept open creates several problems. The taxpayer must retain all records for those years for a substantially longer period of time than otherwise would be the case. Leaving the statute of limitations open for the entire return because of an item which may well be relatively minor is also contrary to the policy of prompt resolution of tax disputes. A taxpayer may also want a prompt resolution of other items on his return in order to limit his potential interest cost as to any deficiency arising from items not related to the section 183 issues on his return.

In order to accomplish the purposes which Congress sought when it enacted the look-forward presumption of section 183(e), it is not necessary to keep the statute of limitations open for all issues on the taxpayer's return during the 5 (or 7) year period. The only issues on which the statute of limitations needs to remain open concern the deductions which will be tested as to whether they are incurred in an activity which the taxpayer engaged in for profit. Congress believes that a taxpayer should be able to take full advantage of a statutory presumption which was intended for his benefit, without unnecessarily extending the statute of limitations for items on his return which are unrelated to deductions which might be disallowed under section 183.

Explanation of provision

The Act revises prior law (sec. 183(e)) to provide that if a taxpayer elects to postpone the determination of his conduct of an activity under the presumption provisions, the statutory period for the assessment of any deficiency specifically attributable to that activity during any year in the 5 (or 7) year period shall not expire until at least two years after the due date of the taxpayer's income tax return for his last taxable year in the period.

If a taxpayer makes an election under section 183(e) and postpones a determination whether he engaged in a particular activity for profit, the making of this election automatically extends the statute of limitations, but only with regard to deductions which might be disallowed under section 183. The taxpayer would not have to agree to extend the statute of limitations for any other item on his return during the 5 (or 7) year period. On the other hand, even if the taxpayer has petitioned the Tax Court with regard to an unrelated issue on his return for any year in the same period, the Service will be able to issue a second notice of deficiency relating to a section 183 issue as to any taxable year in the period.

In order to assure the Service adequate time to reexamine the section 183 issue after the suspension period has ended, this new provision allows the Service two years after the end of the period in which to contest the taxpayer's deductions. The making of the election extends the statute of limitations on any year in the suspension period to at least two years after the due date of his return for the last year in the period.[33] (The due date is to be determined without regard to extensions of time to file his return for the last year.)

The taxpayer's limited waiver of the statute of limitations would include not only the section 183 issue itself but also deductions, etc., which depend on adjusted gross income and which might be affected if the deductions are disallowed in accord with section 183.

The provision for this limited waiver is not intended to affect the scope or duration of any general waivers of the statute of limitations which taxpayers have signed (or sign) before the date of enactment of this Act (October 4, 1976).[34]

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[33] The Act does not shorten the usual 3-year statute of limitations as to any taxable year in the 5 (or 7) year period. Rather, it requires that the normal limitations period be extended as to any year in the 5 (or 7) year period as to which the normal 3-year limitation period would otherwise expire while the potential section 183 issues are held in suspense.

[34] The provision is not designed to affect existing general waivers of the statute of limitations, because to do so would allow taxpayers who have previously signed such waivers to escape an examination of issues not related to section 183 even though the Internal Revenue Service had attempted to make a timely audit of them. Thus, for example if, before the date of enactment of this bill, in examining a taxpayer's income tax returns for 1970, a revenue agent had proposed adjustments to a taxpayer's allegedly unsubstantiated charitable contributions and to his horse breeding activities, and if the taxpayer made an election under section 183(e), and signed a general waiver of the statute of limitations until October 15, 1978 (i.e., until 18 months after the due date of his 1976 return), the agent could issue the taxpayer a deficiency notice for both items at any time prior to that date. After that date, however, the statute of limitations would continue to be open for issues relating to horse breeding activities conducted in 1970 until April 15, 1979, but would be closed for issues relating to the proper substantiation of charitable contributions after October 15, 1978.

Similarly, the bill does not affect general waivers of the statute of limitations which may be signed after enactment, since in order to avoid two controversies relating to overall income tax liability for the same year, a taxpayer may wish to postpone a resolution of non-section 183 issues until the information relating to the section 183 presumption is available.

Effective date

This provision generally applies to taxable years beginning after December 31, 1969. However, it will not permit a reopening of the statute of limitations for any taxable year ending before the date of enactment of the bill and as to which the statute of limitations has expired before such date of enactment. Further, since this provision does not limit general waivers of the statute of limitations, a taxpayer who has previously signed a general waiver will not be able to take advantage of this new provision (and to argue that the statute of limitations has run on issues unrelated to section 183) until his general waiver expires.

Revenue effect

This provision is not expected to have any revenue effect.

4. Oil and Gas

a. Limitation of Loss to Amount at Risk (see sec. 204 of the Act and sec. 465 of the Code)

Prior law

Under the tax law, an owner of an operating interest in an oil or gas well is allowed the option (under sec. 263(c)) to deduct as a current expense the intangible drilling and development costs connected with that well. Intangible drilling costs include amounts paid for labor, fuel, repairs, hauling and supplies which are used in drilling oil or gas wells, the costs of clearing of ground in preparation for drilling, and the intangible costs of constructing derricks, tanks, pipelines and other structures and equipment necessary for the drilling of the wells and the preparation of the wells for production. But for the statutory election to deduct these costs currently, they would, in the case of a successful well, be added to the taxpayer's basis and recovered through depletion and depreciation; in the case of a dry hole, the intangible costs would be deducted at the time the dry hole is completed.

In the case of an oil and gas drilling venture, which is most often a limited partnership, the Service has ruled (in Rev. Rul. 68–139, 1968–1 C.B. 311) that a limited partnership may earmark a limited partner's contribution to expenditures for intangible drilling costs, thereby allowing the allocation of the entire deduction to the limited partners (if the principal purpose of such allocation is not the avoidance of Federal taxes).

The Service has also ruled (Rev. Rul. 71–252, 1971–1 C.B. 146) that a deduction may be claimed for intangible drilling costs in the year paid, even though the drilling is performed during the following year, so long as such payments are required to be made in the first year under the drilling contract in question.

Generally, the amount of losses which a taxpayer is permitted to take in connection with a business or investment in an oil or gas property is limited to the amount of his basis in the property. In the case of a partnership investing in oil and gas properties, the amount of losses a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership. However, under prior law, basis in a property could include nonrecourse indebtedness (i.e., a loan on which there is no personal liability) attributable to that property. Where a partnership incurred a debt and none of the partners had personal liability on the loan, then all of the partners were treated for tax purposes as though they shared the liability in proportion to their profits interest in the partnership (i.e., each partner's share in the nonrecourse indebtedness was added to his basis in the partnership).

Reasons for change

The use of leverage through nonrecourse loans in an oil or gas drilling fund expanded the tax shelter potential of these investments to the extent that the leveraged amounts are used for intangible drilling and development costs. In these cases investors could deduct amounts to produce losses sufficiently in excess of their cash investment so that the tax savings in the year of investment could exceed the amount invested. For example, an investor contributing $100,000 to a partnership for a 10 percent profits interest could have added to his basis another $100,000 if the partnership obtained a nonrecourse loan for $1,000,000. If all of the partnership's capital ($2,000,000) were spent on drilling costs and the partnership had no income, the investor could deduct all of his share of those costs, or $200,000. If the investor were in the 70 percent tax bracket, that deduction would reduce his taxes in that year by $140,000, or $40,000 more than his investment.

This leveraging of investments to produce tax savings in excess of amounts invested has substantially altered the economic substance of the investments and distorted the working of the investment markets. Taxpayers could be led into investments which were otherwise economically unsound and which constituted an unproductive use of the taxpayer's investment funds.

Explanation of provisions

To prevent a taxpayer from deducting a loss in excess of his economic investment in an oil or gas property, the Act provides that the amount of any loss incurred in connection with an oil or gas property may not exceed the aggregate amount with respect to which the taxpayer is at risk at the close of the taxable year. (The detailed provisions of the at risk rule have been discussed in section 2 above.) The limitation applies to all taxpayers (other than corporations which are not subchapter S corporations or personal holding companies) including individuals and sole proprietorships, estates, trusts, shareholders in subchapter S corporations, and partners in a partnership which con-
dividuals and sole proprietorships, estates, trusts, shareholders in

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[1] Since, except for subchapter S corporations and personal holding companies, this provision does not limit the deductibility of amounts paid or incurred by corporation, the provision would not apply to partners in a partnership which are corporations (other than subchapter S corporations and personal holding companies).

In general, in the case of an activity engaged in by an individual other than through a partnership, each oil and gas property (determined on a property-by-property basis, as defined for purposes of computing depletion under section 614) is treated as a separate activity. However, in the case of a partnership or subchapter S corporation, all oil and gas properties are to be treated as one activity.

For purposes of the 65 percent of net income limitation (under section 613A(d)), and the 50 percent of income from the property limitation (under section 613(a)), the deduction for intangible drilling and development costs is to be taken into account without regard to the at risk provision (i.e., on the assumption that the intangible drilling and development costs are fully deductible).

As discussed above, where the taxpayer has no personal liability with respect to a loan, he is to be considered at risk with respect to any indebtedness where the loan is secured by the taxpayer's personal or partnership assets (other than assets which are used in the same activity) which have an established value, to the extent of the value of the assets (net of any other nonrecourse indebtedness secured by these same assets). In the case of oil and gas wells, a property is not considered to have an established value unless sufficient drilling has taken place to establish proven reserves on the property.

Effective date

This provision is to apply to losses attributable to amounts paid or incurred with respect to oil and gas properties after December 31, 1975, in taxable years beginning after that date.

Revenue effect

This provision will increase budget receipts by $50 million in fiscal year 1977, $18 million in fiscal year 1978, and $6 million in fiscal year 1981.

b. Gain From Disposition of an Interest in Oil and Gas Property (sec. 205 of the Act and sec. 1254 of the Code)

Prior law

Under the tax law, the operating interest in an oil or gas property is considered to be either a capital asset or real property used in a trade or business. As a result, where the operating interest is sold after being held for more than six months,[2] the income from the sale will qualify for treatment as long-term capital gain. Similarly, an interest in a partnership is generally treated as a capital asset the sale of which will qualify for long-term capital gain treatment.

Prior law provided for the recapture of any deductions upon the sale of oil or gas property only to the extent that any deductions taken (under sec. 167) for the depreciation of tangible personal property (sec. 1245). Amounts deducted currently for intangible drilling and development costs (under sec. 263(c)) were not subject to recapture.

General reasons for change

The provision allowing gain from the sale of oil or gas property to be treated as capital gain without any significant recapture of deduc-

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[2] The required holding period is increased to nine months for taxable years beginning in 1977 and to one-year for years beginning after 1977 under section 1402 of the Act.

tions taken against ordinary income increases the value of an oil and gas tax shelter investment because it permits an investor, who has obtained a deferral of tax through the deduction of intangible drilling and development costs, to convert amounts which would in later years be taken into account as ordinary income into capital gains subject to the lower capital gains tax rates. The opportunity to convert these amounts into capital gains by selling the property occurs in all cases of producing wells where the option to deduct intangible drilling costs has been made. Even apart from tax shelter considerations, the Congress sees no reason why the principle which applies to other areas of the tax law (i.e., that deductions attributable to property should be subject to recapture if that property is sold or disposed of) should not also apply here.

Explanation of provisions

The Act provides for the recapture of certain intangible drilling and development costs upon the disposition of oil and gas properties if the disposition takes place after December 31, 1975. The amount subject to recapture is the amount deducted for intangible drilling and development costs (paid or incurred after December 31, 1975), reduced by the amounts which would have been deductible had those intangible costs been capitalized and deducted through cost depletion. However, the amount recaptured cannot exceed the amount of gain realized from the disposition. The amount recaptured is to be treated as gain which is ordinary income and is to be recognized upon the disposition of the property, regardless of any other provision of the Code which would otherwise provide for nonrecognition.

The recapture provision applies to all intangible drilling and development costs which, but for the option to deduct these costs under section 263(c), would be reflected in the adjusted basis of the property at the time the costs are paid or incurred. Amounts subject to recapture are to be reduced by the amount of cost depletion attributable to those intangible drilling and development costs actually deducted or permitted to be deducted under cost depletion (under sec. 611).

Costs which, but for the election to deduct intangibles, would be added to basis and recovered through depreciation (rather than to cost depletion) are to be recaptured under this provision.[3]

This net amount of intangible drilling and development costs over the amount allowable under cost depletion is to be treated as ordinary income only to the extent of any gain realized (or to the extent of the excess of the fair market value of the property transferred over the basis in the property). This limitation on the amount recaptured to the amount of gain (or the excess of fair market value over basis) is the same limitation applied (under sec. 1245) for the recapture of certain depreciation or amortization expenses relating to personal property. The computation of the amount realized, the fair market value of any interest, and the adjusted basis of the property are to be made under substantially the same rules which apply to that provision.

The rules of this provision are to be applied separately to the intangible costs attributable to each oil and gas property. A property is

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[3] These amounts were not, of course, previously subject to recapture under sec. 1245, since they are deducted under sec. 263(c) and not under secs. 168, 169, 184, 185, 187, or 188, as is required under sec. 1245(a)(2).

defined for purposes of these rules in the same way as under the existing rules (under sec. 614) for purposes of computing the amount of depletion allowable. Thus, each different taxpayer's interest in a tract or parcel of land is generally to constitute a separate property, but all of a single taxpayer's operating interests in one tract or parcel of land are generally to be combined. However, if one or more taxpayers combine their interests for depletion purposes under a pooling or unitization agreement (as described in sec. 614(b)(3)), the property is to include all of the interests as so combined.

A property is to be considered an oil or gas property only if intangible drilling and development costs are properly chargeable to that property (either in the hands of the taxpayer or his predecessor in interest). Thus, an interest in a tract or parcel of land which is not an operating interest does not constitute an oil or gas property.

The recapture rule is to apply to all taxpayers who own oil or gas properties, including citizens and residents, trusts and estates, and corporations.

The recapture rule applies to the disposition of all or any portion of an oil or gas property. In the case of a disposition of a portion of an oil or gas property other than an undivided interest, the entire amount of intangible costs attributable to that property are to be allocated to the portion of the property which is first disposed of. Any excess of intangible costs not recaptured in the first disposition of a portion of an interest other than an undivided interest (because, for example, the gain realized from the disposition was less than the amount of costs subject to recapture) is to be subsequently allocated to the remaining portions of the oil or gas property. However, in cases of dispositions of a portion of an oil or gas property which are not subject to recapture under this provision (such as gifts), a proportionate part of the intangible costs subject to recapture is to be treated as allocable to the portion of the property transferred and is to be treated in the hands of the transferee as a transfer of a separate oil or gas property.

In the case of a disposition of an undivided interest in an oil or gas property or in a portion of an oil or gas property, a proportionate part of the intangible costs attributable to that property are to be allocated to the undivided interest and recaptured to the extent of the gain from the disposition of the undivided interest. For purposes of this rule (as well as for purposes of the rule relating to gifts and other nonrecapture dispositions as discussed in the next paragraph), it is intended that the expenditures are to be allocated in proportion to the rights to income from the property.

The recapture rule is to apply to all dispositions generally except those which are not treated as dispositions under the existing recapture provisions relating generally to gains from the disposition of depreciable personal property (sec. 1245). This provision excepts from recapture dispositions by gift, transfers at death, transfers in certain tax-free reorganizations, like-kind exchanges and involuntary conversions in certain circumstances, and certain sales or exchanges required by order of Federal agencies. These same exceptions are to be applied under regulations in the appropriate manner to the recapture of intangible drilling and development costs from oil or gas properties. Also, for purposes of this provision a unitization or pooling arrangement (within the meaning of section 614(b)(3)) is not to be treated as a disposition.[4]

In addition, the rules relating to the distribution of property by a partnership to a partner which are applied (under sec. 617(g)) to distributions of any property or mine with respect to which mining exploration expenditures have been deducted are to be applied in a similar manner to the distribution of oil or gas property to a partner and to the distribution of other property to a partner by a partnership which, after the distribution, continues to hold oil or gas property.

For purposes of these rules, where a partner sells or exchanges his interest in a partnership holding an interest in oil or gas property, intangible drilling costs which would be subject to recapture under these provisions (should the partnership dispose of its interest in the property) are to be treated as an unrealized receivables (within the meaning of section 751). Thus, any gain realized by the partner upon the sale or exchange of his interest would be subject to ordinary income treatment to the extent of his share of these costs. Similar rules are to apply upon the sale or exchange of stock in a subchapter S corporation (in accordance with regulations to be prescribed by the Secretary or his delegate).

Effective date

The rules providing for the recapture of deductions for intangible drilling and development costs are to apply to dispositions of oil and gas properties in taxable years ending after December 31, 1975, with respect to intangible drilling and development costs paid or incurred after December 31, 1975.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of $7 million for fiscal year 1977, $14 million for 1978, and $65 million for 1981.

5. Motion Picture Films

a. At Risk Rule and Capitalization of Production Costs (secs. 204 and 210 of the Act and secs. 280 and 465 of the Code)

Prior law

Under prior law, motion picture shelters generally had two basic forms. In one format, a limited partnership was formed to purchase the rights to an already completed film. The purchase price was heavily leveraged (and often unrealistically inflated) and the partners claimed substantial depreciation deductions. The principal features of the shelter was deferral and leverage. This format was sometimes referred to as a "negative pick-up" or "amortization purchase" transaction.

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[4] Also, arrangements under which the interests of two or more parties in a drilling venture (such as a leaseholder and a driller) shift after a certain amount of production is obtained are not generally to be considered a disposition where the shift in interests occurs under an agreement made prior to the time that the intangible drilling expenses were paid or incurred.

In the second type of format, the limited partnership was formed to produce a film (rather than to buy a completed film). The partnership entered into an agreement with a studio, with a distributor or with an independent producer to produce a particular film. The partnership used the cash method of accounting and wrote off the costs of production as they were paid. Typically the partnership was heavily leveraged and significant costs were paid with borrowed funds. The principal elements of this form of motion picture shelter were also deferral and leverage. The partnership in this type of shelter was sometimes referred to as a "service company" or "production company."

Another variation of this shelter was the film distribution partnership. In this shelter, the partnership also did not own an interest in the film, but obligated itself to distribute the film. By writing off the costs of distribution, the deferral occurred for the partners because the partnership's income from its distribution services was not realized until later years.

The basic principles of partnership tax law which benefited the motion picture tax shelter (and other shelters as well) included the use of the partnership form to allow limited partners to take into income their distributive share of the partnership's income or losses (which are generally determined under the partnership agreement). Also, the amount of partnership loss which the partner may deduct included not only his own equity contributions to the partnership, but also his share of any nonrecourse debt which the partnership has incurred (see regulations § 1.752–1(e)). There were also several aspects of prior law, however, which relate particularly to motion picture shelters.

(1) Film purchase shelter

The income forecast method.—Motion pictures were usually (and may continue to be under the Act) depreciated on the "income forecast" method. (Rev. Rul. 60–358, 1960–2 C.B. 68; Rev. Rul. 64–273, 1964–2 C.B. 62.) This method is used because, unlike most other depreciable assets, the useful life of a motion picture is difficult to ascertain. Under the income forecast method, the taxpayer computes depreciation by using a fraction, the numerator of which is the income received from the film during the year and the denominator of which is the total estimated income which the film is expected to generate over its remaining lifetime. This fraction is then multiplied by the cost of the film. For example, if the taxpayer has a basis of $500,000 in his interest in the film, the income from the film through the end of the first year is $750,000, and the total estimated income from the film over its lifetime is $1,000,000, the taxpayer would be allowed to depreciate 75 percent of his basis, or $375,000. (If the income forecast increases or decreases as a result of changed circumstances, this change is taken into account for later periods. Thus, in the second year, depreciation under the income forecast method might be based on an income forecast denominator which was more or less than the amount used for the first year.)

The film purchase transaction worked as a tax shelter only where the purchase price of the film (including nonrecourse indebtedness) exceeded its economic value.[1]

However, there was a substantial question even under prior law whether taxpayers in a film-purchase shelter were legally entitled to claim depreciation based on nonrecourse indebtedness where the "purchase price" of the film was in excess of the income forecast on the film.

While the authorities in this area have not been uniform, there are several cases which have disallowed the depreciation deduction based on nonrecourse liability where there was no substantial prospect that this liability would be discharged. In *Leonard Marcus*, 30 T.C.M. 1263 (1971), the court held that where the taxpayer purchased two bowling alleys for a 5 percent down payment, with a 20-year nonrecourse note for the balance, the taxpayer could depreciate only the basis represented by his down payment, and that the note could be taken into account for purposes of increasing the taxpayer's basis only to the extent that payments were actually made. The court held that the liability represented by the note was too contingent to be included in basis until payments were made.[2]

In *Marvin M. May*, 31 T.C.M. 279 (1972), the Tax Court held that a transaction in which the taxpayer purchased 13 television episodes for $35,000, and obligated himself to pay an additional $330,000 on a nonresource basis was a sham, because this amount was far in excess of the fair market value of the films and there was no realistic prospect (or intention) that the debt would ever be paid. Therefore the court disallowed the depreciation deduction claimed with respect to the film. See also Rev. Rul. 69–77, 1969–1 C.B. 59.[3]

It would seem that some of these same principles could often be applied in the case of a film purchase shelter, where the purchase price of the film consists largely of nonrecourse indebtedness and substantially exceeds the film's income forecast.

Depreciation recapture.—There is some question as to whether a movie film in the hands of a limited partnership, such as those described here, constitutes a capital asset (within the meaning of sec. 1221), or "property used in the trade or business" of the taxpayer

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[1] Assume, for example, that a limited partnership pays $1,000,000 for a film (consisting of $200,000 in cash and a 10-year nonrecourse note for $800,000). After the film is released, it becomes apparent that the film may not be successful and an income forecast of $200,000 is made for the film. Assuming $160,000 of this revenue (or 80 percent of the predicted total) were realized in the first year, the partners would depreciate 80 percent of their basis in the film, or $800,000 for a net tax loss (after taking account of the $160,000 of income from the film) of $640,000.

On the other hand, where the income stream is equal to or greater than the purchase price there was no shelter. For example, if the film is purchased for $2 million (and has this as its basis), but has an estimated income stream of $4 million, $3 million of which is earned during the first year, the result would be as follows. The partners would be allowed to take 75 percent of their $2 million basis as depreciation in the first year under the income forecast method (or a $1,500,000 deduction). However, the film would be also generating $3 million of income which the partners would have to recognize. Thus, the net tax effect would be positive taxable income to the partners of $1,500,000. Where the purchase price of the film and its estimated income stream are exactly equal, the depreciation deduction and the amount of income from the film should exactly offset each other.

[2] In *Marcus*, the 20-year term of the note was substantially in excess of the useful life of the bowling alleys.

[3] As indicated above, under the partnership provisions, the partner could add to his basis in the partnership his share of the nonrecourse liabilities. However, section 752(c) provides that "a liability to which property is subject" shall be considered as a liability of the owner of the property "to the extent of the fair market value of such property . . ." Since the "fair market value" of a movie film ordinarily will not exceed its total projected lifetime earnings, this suggests that a partner's basis could not, even under prior law, include his share of nonrecourse indebtedness to the extent that this indebtedness (plus the partner's down payment) exceeded the income forecast for the film.

which is neither "inventory," nor "property held by the taxpaper primarily for sale to customers in the ordinary course of his trade or business" (within the meaning of sec. 1231).

If the film is not a capital asset (or section 1231 property), any income received with respect to the film would be ordinary income. Assuming that the film is found to be a capital asset, income realized on the sale or exchange of the film would be subject to the depreciation recapture rules of section 1245. Thus, the proceeds of the sale in excess of the taxpayer's adjusted basis would constitute ordinary income to the extent of any depreciation previously allowable with respect to the film.[4]

Even if the film is not sold, there should eventually be recapture of the depreciation attributable to the unpaid balance of a nonrecourse note which entered into the depreciable basis of the film. If the film is successful and the loan is repaid out of the partnership income, each partner must take into income his distributive share of the amounts used for repayment; the partner's basis would not be affected. (The partner's basis would increase to the extent that his distributive share of the partnership income was used for partnership purposes, such as repayment of the loan, but his basis would decrease in an equal amount because his share of the nonrecourse partnership liability was being reduced by the repayment.) If the film is not successful and the nonrecourse debt becomes worthless, a default, foreclosure or abandonment of the debt generally constitutes income to the partnership because such events are treated as a "sale" of the movie film, which is subject to the recapture rules of section 1245.[5]

The rules on depreciation recapture are essentially the same under prior law and under the Act.

(2) Production company shelter

Cash method of accounting.—Under prior law, obtaining tax deferral through a production company transaction depended on whether the partnership could properly deduct its costs of producing the film as it paid them. This in turn depended on whether proper tax accounting practices permitted the partnership to treat these costs as an item of expense or required the partnership to capitalize these expenditures and amortize them over the life of the asset. (In this case, the asset was the partnership's rights under the contract with the distributor-owner of the film.)

Under prior law (and present law), a taxpayer is generally permitted to select his own method of accounting (sec. 446(a)) unless the method selected "does not clearly reflect income" (sec. 446(b)). If it does not, the law permits the IRS to compute the taxpayer's income in a way that will clearly reflect his income.

One problem with the motion picture service partnership's use of the cash method under prior law was the possibility that a particular partnership is really engaged in a joint venture with the distributor or with an independent producer, i.e., the investors provided financing

[4] If the partner sold his interest in the partnership, the depreciation would be recaptured as an "unrealized receivable" under section 751.

[5] Likewise, if the partnership discontinues its operations, this should constitute a constructive distribution of the partnership assets (including, for this purpose, the unpaid portion of the nonrecourse note) to the partners, which in turn triggers the recapture rules of section 1245.

and the studio/distributor or producer supplied personnel, production skills and also loan guarantees. As part owners of the film, the partnership would then have to capitalize its production costs.[6]

In such circumstances the question is whether failure to capitalize the expenses of producing the film (and thus, of the partnership's rights under the contract) results in a material distortion of income. There is a strong argument, even under prior law, that a material distortion of income does occur under these circumstances. See *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), holding that "accepted accounting practice" and "established tax principles" require the capitalization of the cost of acquiring a capital asset, including costs, such as depreciation on equipment, which would generally be deductible if they were not allocable to the construction of the asset. (The production company's contract rights are not a capital asset, but these rights are an asset with a long useful life, so there is a strong argument that the capitalization principle should apply.)

On the other hand, there is one case relied on heavily in the past by the investors in movie production partnerships which held that a building contractor's income was not distorted where the company constructed apartments and shopping centers under long-term construction contracts and deducted its costs on the cash method, while receiving payments over a five-year period after each project was completed. *C. A. Hunt Engineering Co.*, 15 T.C.M. 1269 (1956). Production company investors have argued that the same result should be allowed in their situation.

A related question under prior law is whether a limited partnership producing a motion picture is engaged in selling or delivering a product (the film) and is therefore required to maintain an inventory. If this were the case, the labor costs paid in producing the inventory could not be deducted until the inventory item was sold. The argument against that view is that the production company was selling services (i.e. production services) rather than a product.

Another question under prior law is whether the funds supplied by the limited partners were merely part of a financing transaction in which the investors were basically only loaning money to the distributor or other party who would own the completed film. As creditors, the financing parties would not be entitled to tax deductions for the amounts which they are lending.

(3) IRS rulings position

The Service has issued several revenue rulings with respect to the use of limited partnerships and nonrecourse loans.[7] Although these rulings have applicability outside the area of movie shelters, they also impose some limitations, at least insofar as the position of the Service is concerned, which apply both to the film purchase type transaction, and the production company arrangement.

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[6] In some cases, the personnel hired by the partnership to make the film were not in reality the investors' own employees but were supplied by the studio/distributor. In other cases, the investors' partnership subcontracted actual production work to the studio/distributor (or to its agents). Factors such as these, along with the sharing of profits and risks of loss, the distributor's day-to-day involvement in production and budget changes, etc., would tend to support treatment of the partnership as a participant in a joint venture.

Still another difficult question under prior law for the motion picture "service company" was whether the partnership was conducting a trade or business if it made only one picture or did not operate with regularity.

[7] Rev. Proc. 74–17, 1974–1 C.B. 438; Rev. Rul. 72–135, 1972–1 C.B. 200; Rev. Rul. 72–350, 1972–2 C.B. 394.

These rulings suggest that many forms of nonrecourse loans may, in substance, be equity investments by the lender, which cannot be used by the limited partners to increase their bases in the film or in a production partnership. Purchase money loans by the seller of a film (in a negative pickup transaction) might be included in this category. The logic of these rulings might well apply also to the case where a loan is made to the investors' partnership by a bank, but is guaranteed by the studio which is selling the film (or for whom the film is being made, in the case of the production company shelter).

Reasons for change

The two formats commonly employed in connection with movie films, the film purchase shelter and the production company shelter, had the same basic elements, i.e., tax deferral and the use of leverage. In the case of the film purchase shelter, deferral occurred because of the rapid depreciation which is allowed in connection with movie films, and which is passed through to the limited partners, particularly in cases where the film is not economically successful. In the case of the production company, the mismatching of expenses and income occurred because the partnership deducts the full cost of producing the film before the film is released and because the contract which the limited partnership enters with the "owner" of the film (usually a studio-distributor) often provided that payments to the production company for its "services" will be spread over a relatively long time period.

Both types of investments involved the use of leverage (i.e., nonrecourse loans) which allow the limited partners to receive tax deductions for amounts in excess of their economic investment. This result distorted the economic substance of the transaction by permitting the taxpayer to deduct money which he has neither lost nor placed at risk. In the case of movie shelters, the use of very heavy leverage factors was not uncommon.

As indicated above, questions existed under prior law as to whether investors in certain cases were entitled to the deductions they are claiming in connection with movie shelters. Thus, many participants in these shelters may have claimed deductions which will later be disallowed by the Service.[8]

In addition, the Congress was informed that the production company shelter may be expanding into other areas, such as the publishing field.

For these reasons, under the Act, the film purchase shelter is to be subject to an at risk rule, to prevent taxpayers from writing off more than their economic investment in this type of transaction. In the case of the production company shelter (including the use of a service company to produce books, recordings and similar property as well as films), the Act requires capitalization of the expenses of production, not only for movies, but also for similar types of service company shelters. In addition, the production company movie shelter is also to be subject to the at risk rule.

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[8] In the case of the film purchase shelter, the principal issue in potential abuse situations is whether the taxpayers have used an inflated basis for purposes of depreciation. In the case of the production company, the issue is whether the partnership has failed to reflect income properly by not capitalizing the production costs of the film. In both shelters, the use of leverage to increase the partners' bases might be subject to question, at least under certain facts and circumstances.

Explanation of provisions

The "at risk" rule

Under the Act, as indicated above, both the film purchase shelter and the production company shelter are to be subject to the at risk limitation. (The provisions of the at risk rule have already been explained in detail in section 2 above.)

In the case of movie films activities engaged in by an individual (other than through a partnership) each film in which the taxpayer has an ownership interest, and each film which the taxpayer produces or distributes, is to be considered a separate activity for purposes of the at risk rule. However, in the case of a partnership (or subchapter S corporation), all films in which the partnership (or subchapter S corporation) has an ownership interest, and all films which the partnership (or subchapter S corporation) produces or distributes, are to be treated as part of one activity.

Amortization of production costs of motion pictures, books, records, and other similar property

To prevent a situation where a taxpayer may attempt to accelerate his deductions in connection with the production costs of a motion picture film (or other property), thus producing a mismatching of income and expenses attributable to the income, the Act provides that a taxpayer is to be required to capitalize his share of the production costs and deduct them over the life of the income stream generated from the production activity. This rule is to apply to persons (other than corporations which are neither subchapter S corporations nor personal holding companies) engaged in the service of producing a film (including the costs of making prints of the film for distribution), sound recording (including discs, records, tapes, etc.) book, or similar property (such as a play, etc.).

Generally, it is anticipated that taxpayers who are subject to this capitalization requirement will (in effect) depreciate their capitalized expenses (in accordance with regulations to be prescribed by the Secretary) under a method analogous to the income forecast method. Thus, the production costs will be written off by the taxpayer over the useful life of the asset which he has acquired as a result of his investment. In the case of a service company shelter, the asset will be the taxpayer's contract rights under his contract with the motion picture distributor, publisher, etc.

For purposes of these rules, the numerator of the income forecast fraction will be the income which the taxpayer has received under the contract. The denominator of the fraction is to be the total income which the taxpayer may reasonably expect to receive under the contract. Thus, in the case of a film service partnership, for example, the denominator of the fraction is to include the partnership's share of any anticipated income from the film (where the partnership is compensated by a percentage of income from the film), as well as any guaranteed payments which the partnership is to receive under the contract, and any income from the discharge of indebtedness. Of course each item of anticipated income is to be taken into account only once; thus, where a partnership is entitled to 10 percent of gross income from the film, with a guaranteed payment of $1 million, the denominator of the income forecast fraction would be the greater of (1) 10 percent of the anticipated gross revenues from the film, or (2) $1 million (so as to avoid double counting).

Effective dates

Under the Act, the at risk rule is to apply to losses attributable to amounts paid or incurred (or amounts allowable as depreciation or amortization) in taxable years beginning after December 31, 1975. The at risk provision does not apply to a film purchase shelter if the principal photography began before September 11, 1975, there was a binding written contract for the purchase of the film on that date, and the taxpayer held his interest in the film on that date. The at risk rule also does not apply to production costs, etc., if the principal photography began before September 11, 1975, and the investor had acquired his interest in the film before that date.

Under a second transition rule in the Act, this provision will not apply to costs of producing, displaying or distributing a film, in the case of a film production partnership, if (1) the principal photography begins before January 1, 1976, (2) the picture is to be produced within the United States,[9] and (3) there was binding written agreement in effect on September 10, 1975 (and at all times thereafter) between a director (or a principal star) for the picture and the partnership which will produce the film. An alternative to the third of these requirements may also be satisfied: under this alternative, on September 10, 1975, there must have been expended, or irrevocably committed, to the film the lower of (1) $100,000 or (2) 10 percent of the reasonably estimated total production costs of the film. This second transititon rule applies, however, only to taxpayers who held their interests in the film (or in a partnership which will produce the film) on or before December 31, 1975.

In applying the at risk provisions to activities which were begun in taxable years beginning before January 1, 1976 (and not exempted from this provision by the above transition rules), amounts paid or incurred in taxable years beginning prior to that date and deducted in such taxable years will be generally be treated as reducing first that portion of the taxpayer's basis which is attributable to amounts not at risk. (On the other hand, withdrawals made in taxable years beginning before January 1, 1976, will be treated as reducing the amount which the taxpayer is at risk.)

The capitalization requirement applies to costs of producing a film (i.e. a production partnership) or other similar property, if such costs are paid or incurred after December 31, 1975, and the principal production of the property began after that date. In the case of a film, principal production means principal photography; in the case of a sound recording, principal production is the date of the recording; in the case of a book, principal production begins with the preparation of the material for publication; in the case of other similar property, the commencement of principal production is to be determined in accordance with regulations.

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[9] For purposes of this rule, a film is to be treated as being produced in the United States if at least 80 percent of the "direct production costs" of the film are paid or incurred for U.S. production (see discussion of this issue in connection with the "Investment Credit in the Case of Movies and Television Films," *infra*).

As indicated above, in the case of both the film purchase shelter and the "production company" shelter there are some substantial questions under prior law as to whether the deductions which are claimed in connection with some of these shelters are allowable. (Such questions include the amount of depreciation which may be claimed, whether the deduction or capitalization is the appropriate treatment with respect to costs of production, and whether nonrecourse loans should be treated as debt or equity, etc.) In establishing transition rules with respect to the new restrictions on the deductibility of these items as added by the Act, the Congress intends to make clear that these transition rules are not to be read as implying that deductions not otherwise allowable under prior law are to be allowable until the capitalization requirement and at the risk rule take effect. No inference is intended that such deductions were allowable under prior law and, quite to the contrary, it appears that, at least under certain facts and circumstances, the questions as to the nonallowability of certain of these deductions under prior law are very substantial.

Revenue effect

It is estimated that the provisions with respect to the at risk requirement will result in an increase in budget receipts of $3 million for fiscal year 1977, $10 million for 1978, and $18 million for 1981. It is estimated that the capitalization requirement will result in an increase in budget receipts of $29 million for fiscal year 1977, $19 million for 1978, and $4 million for 1981.

b. Clarification of Definition of Produced Film Rents (sec. 211 of the Act and sec. 543 of the Code)

Prior law

Under prior law (and under the Act), a corporation which is a personal holding company is taxed on its undistributed personal holding company income at a rate of 70 percent (sec. 541). A corporation is a personal holding company where five or fewer individuals own more than 50 percent in value of its outstanding stock and where at least 60 percent of the corporation's adjusted ordinary gross income comes from specified types of income.

One income category treated as personal holding company income is "produced film rents." Generally, this category covers payments received by the corporation from the distribution and exhibition of motion picture films if these rents arise from an "interest" in the film acquired before its production was substantially completed (sec. 543 (a)(5)(B)). Produced film rents are not treated as personal holding company income, however, if such rents constitute 50 percent or more of the corporation's ordinary gross income. The qualifying rental interest under this category is one which arises from participation in the production of the film. In such cases Congress has regarded production activities as an active business enterprise.

Amounts received pursuant to a contract under which the corporation is to furnish personal services may be classified, under certain conditions as personal holding company income (sec. 543(a)(7)).

These statutory rules affect, among others, independent motion picture and television producers, actors, directors, writers, etc. (or persons possessing more than one of these skills), who form corporations through which they participate in making motion picture or television films.

Reasons for change

A question concerning the proper definition of produced film rents, for purposes of the personal holding company rules, has resulted from a recent decision by the Tax Court [10] which denied depreciation deductions to an independent production company which produced an original motion picture with nonrecourse financing supplied by a major studio-distributor under an agreement that, on completion, all rights to the picture except a share in distribution profits vested in the distributor. The court held that, in these circumstances, the production company had no ownership interest in the film after it was completed and therefore could not depreciate the costs of producing film.

Although this case involved depreciation rather than personal holding company issues, it appears that the Internal Revenue Service has interpreted the decision to require that an "interest" in a film, for purposes of the definition of produced film rents in sec. 543(a)(5), must be a depreciable interest. If a production company has only a profit participation after the picture is completed and released, but legally does not have an ownership interest sufficient to claim depreciation, some revenue agents have treated all of the company's income as personal service contract income (under sec. 543(a)(7) of the Code).

Congress decided that a production company does not have to have a depreciable interest in a picture it makes in order for its profits interest to qualify as produced film rents. The test under section 543 (a)(5) should be whether the company in fact produced the film.

Explanation of provision

In order to avoid ambiguities, the Act (sec. 543(a)(5)(B)) sets forth more clearly the nature of the qualifying "interest" in a film. In the case of a producer who actively participates in producing a film, the term "produced films rents" will include an interest in the proceeds or profits from the film, but only to the extent that this interest is attributable to active participation in production activities.[11]

Under this provision, a production company will be considered a "producer" if it engages in production activities and is involved in principal photography or taping of the production. The term "producer" also includes participation in qualifying production activities as a co-producer.

Qualifying production activities cover preproduction activities, principal photography or taping, and postproduction functions necessary to produce a film or television tape. Preproduction activities include acquiring literary rights on which the film is to be based; developing a shooting script, supervising writers, preparing budgets, scouting locations and employing crews to be involved in the production. Activities during principal photography (or taping) include administration of budgeted items, contracting for production facilities, actual filming or taping and reviewing rough cuts. Postproduc-

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[10] Carnegie Productions, Inc., 50 T.C. 642 (1973).

[11] Other requirements in the existing definition of produced film rents must also be satisfied, namely, that the payments received by the producer are for the use of, or right to use, the film and that the interest must be acquired before substantial completion of production of the film.

tion activities include film editing, dubbing, musical scoring, synchronizing, showings to exhibitors or other previewers, re-editing and delivering the completed film (or tape) for showing to the public.

If the income of a corporation qualifies as produced film rents under this provision, as amended, the Congress believes that such income should not be subject to being treated as income from personal service contracts (for purposes of section 543(a) (7)).

On the other hand, if all or part of the conduct of production activities lacks substance or is otherwise not *bona fide* (such as a corporation which primarily provides the services of an actor or actress who is nominally named "producer"), the Service is not to be precluded from attributing part of the company's income to personal service contracts (if the requirements of sec. 543(a) (7) are otherwise present).[12]

Congress does not intend the amendment made by this provision to affect depreciation questions, *e.g.*, whether a production company owns a depreciable interest in a film financed by nonrecourse loans.

Effective date

This amendment applies to taxable years ending on or after December 31, 1975. The Congress intends that no inference should be drawn from this change as to whether, before the effective date of this amendment, the definition of produced film rents required the corporation to have a depreciable interest in the film under production.

Revenue effect

It is estimated that this provision will result in a reduction in budget receipts of less than $5 million annually.

6. Equipment Leasing—Limitation on Loss to Amount At Risk (sec. 204 of the Act and sec. 465 of the Code)

Prior law

Accelerated depreciation.—The owner of personal property used for the production of income may generally claim annual deductions for depreciation to reflect the approximate decline in the value of the property over the period of the owner's use of the property. These depreciation deductions are also available where the owner is not the actual user of the property, such as in a leasing transaction where the owner leases the depreciable property to another party who has possession and use of the property. In certain cases where title to the depreciable property is held for the benefit of individual investors by a legal entity, such as a partnership or grantor trust, the depreciation deductions are passed through them to the individual taxpayers who own the actual beneficial interests in the property and are deducted on these taxpayer's income tax returns.

There are a number of depreciation methods. One depreciation method for tangible personal property is the straight-line method, under which an equal portion of the property's depreciable basis is deducted each year of the property's useful life.

[12] A corporation which "loans out" the services of an actor, writer, director, or individual producer employed by it to another company which produces the picture should also not be considered to receive produced film rents. In that type of case, the loaned-out employee does not assume the business risks involved in producing the picture.

Equipment leasing transactions have often characterized, however, by use of one of the accelerated methods of tax depreciation which allow large deductions initially, with gradually reduced deductions for each successive year of the asset's useful life. The accelerated depreciation methods allowed for productive equipment include the double-declining balance method and the sum-of-the-years-digits method.

Additional first-year depreciation.—An owner of equipment may also elect, for the first year the property is depreciated, a deduction for additional first-year depreciation of 20 percent of the cost of property which has a useful life of six years or more (sec. 179). The amount of cost on which this "bonus" depreciation is calculated is limited to $10,000 per taxable year ($20,000 for an individual who files a joint return). The maximum bonus depreciation in any taxable year is as a result limited to $2,000 ($4,000 for an individual filing a joint return).

Where the lessor is a partnership, the election for bonus depreciation is made by the partnership. However, the dollar limitation described above was, under prior law, applied to the individual partners rather than the partnership entity. For example, each one of 40 individual investors who contribtued $5,000 to an equipment leasing limited partnership, which purchased a $1 million executive aircraft on a leveraged basis, would be entitled to $4,000 of bonus depreciation if he filed a joint return. In this case, additional first-year depreciation would have provided a total deduction to the partners of $160,000. (This provision in prior law has been changed by sec. 213(a) of the Act.)

The additional first-year depreciation reduces the depreciable basis of the equipment. However, the partnership is still entitled to claim, and the partners to deduct, accelerated depreciation on the reduced basis in the property both for the first year and for the later years of the property's useful life.

Asset depreciation range (ADR).—The ADR system for depreciation was authorized by the Congress in the Revenue Act of 1971 in order to bolster a lagging economy and to eliminate a number of difficult interpretative problems pertaining to depreciation which had arisen under prior law. The ADR system operates under regulations issued by the Treasury Department, and became effective in 1971. (Reg. § 1.167(a)-11.)

One of the important features of ADR is that taxpayers are allowed to depreciate tangible personal property, including leased property, over useful lives which may vary up to 20 percent from the guideline lives which are otherwise authorized for use under the ADR system.

This means, for example, that an asset with a depreciable useful life of 10 years under the ADR guidelines may instead be depreciated over a period of 8 years, giving the taxpayer a type of "accelerated" depreciation deduction even with straight-line depreciation.[1]

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[1] In computing depreciation under the ADR system, a taxpayer also is entitled to use one of two first-year "conventions," or methods, on all assets first placed in service during any one tax year or period. Under the first of these conventions, the taxpayer may elect to claim a half-year's depreciation on all assets put into service at any time during the year. The other convention allows a full year's depreciation for all assets placed in service during the first half of the tax year and no depreciation (for the first year) on assets placed in service during the last half of the tax year.

Rapid amortization.—Certain categories of assets which are subject to equipment leasing transactions have been eligible for rapid amortization. Under the rapid amortization provisions, the costs for qualifying categories of property may be amortized over a period of 60 months in lieu of depreciation deductions otherwise allowable for these assets. Rapid amortization has been allowed for pollution control facilities (sec. 169), railroad rolling stock (sec. 184), and coal mine safety equipment (sec. 187). These provisions expired at the end of 1975.[2]

Depreciation recapture.—The equipment leasing venture does not give rise to the "conversion" characteristic common in many other types of tax shelters because of the full recapture rules that apply to dispositions of depreciated personal property. When personal property is disposed of at a gain, the gain is "recaptured" as ordinary income to the extent of all previous depreciation or amortization deductions claimed on the property (not just accelerated deductions). The recapture treatment for depreciable personal property thus differs from that accorded depreciable nonresidential real property, which is limited to a recapture of the amount by which accelerated depreciation deductions claimed exceed those allowable on a straight-line basis.

In the case of a partnership, the individual partners are generally allocated a share of the partnership's depreciation recapture in accordance with the provisions of the partnership agreement concerning the allocation of partnership gains. The recognition of depreciation recapture by a partner may be triggered directly by a sale of the depreciated partnership property or indirectly by a disposition of the partner's interest in the partnership itself. Also, if a lender forecloses on the debt used to finance the partnership's purchase of the equipment, this is treated as a disposition which will trigger recapture. The amount "received" in a foreclosure will include the unpaid nonrecourse debt. If this amount exceeds the undepreciated basis in the equipment, there will be so-called "phantom gain" which is taxed as ordinary income to the partners.

Limitation on deduction of losses.—Generally, the amount of deductions or of losses which a taxpayer was permitted to claim in connection with a business or investment property was limited to the amount of his basis in the property. Likewise, in the case of a partnership, the amount of losses a partner may deduct was limited to the amount of his adjusted basis in his interest in the partnership. However, basis in a property may include nonrecourse indebtedness (i.e., a loan on which there is no personal liability) attributable to that property, and where a partnership incurs a debt and none of the partners have personal liability on the loan, then all of the partners are treated for tax purposes as though they shared the liability in proportion to their profits interest in the partnership (i.e., each partner's share in the nonrecourse indebtedness is added to this basis in the partnership). As a result, prior law enabled investors in an equipment leasing activity to deduct losses from the activity in excess the total amount of economic risk the investor had from the activity.

[2] However, amortization for pollution control facilities was extended under Sec. 2112 of the Act.

Also, there was generally no limitation on the amount of deductions that can be taken in situations where the taxpayer is protected against ultimate loss by reason of a stop-loss order, guarantee, guaranteed repurchase agreement, insurance or otherwise.

Reasons for change

A business may acquire productive equipment in a variety of ways, including an outright purchase or a lease of the equipment. Although an outright purchase remains the most common form of acquiring the use of equipment, recent years have shown a substantial growth in the leasing alternative. Some of the more common types of property and equipment which have been leased include computers, aircraft, railroad rolling stock, ships and vessels, and oil drilling rigs. Also, utility companies have begun to lease the nuclear fuel assemblies used in their generating plants.

There are several reasons for the growth in equipment leasing. From the standpoint of the business lessee who uses the equipment, one factor, for example, is the opportunity to acquire use of the equipment in a manner which, in comparison with the purchase alternative, places less strain upon the available cash of the business. Another important advantage for the lessee is that leasing provides greater tax benefits through the ability to deduct its rental costs. There are also significant tax benefits to the lessor in an equipment leasing transaction (such as accelerated depreciation deductions, as discussed above) which attract the participation of individual investors.

The equipment leasing tax shelter generally operates through the limited partnership form of business organization, with the individual investors participating as limited partners. All, or virtually all, of the equity capital of the venture is contributed by the limited partners and non-recouse financing is obtained for 75–80 percent of the cost of the equipment which is purchased by the partnership and leased to a business user. The partnership generally leases the equipment to the lessee at a rental rate which, over the initial term of the lease, will enable the partnership to repay the loan, plus interest, fees and other expenses, and generate a modest positive cash flow.

In most leasing shelters, the limited partnership elects the method of depreciation or amortization which will generate the largest capital recovery deductions allowable in the early years of the lease. The partnership may, in addition, prepay some of its interest charges, and often, during the first year of operation, pays the promoter for management and syndication fees. The large depreciation, fees, interest, and other expenses generally exceed the partnership's receipts from rental of the equipment during the first 3–7 years of the lease (depending upon the estimated useful life of the leased equipment), and this generates sizable losses for the partnership.

Partnership losses are allocated to the investor-limited partners under the partnership agreement and are used by the individual investors to offset income from other sources (and thus defer taxes on this income for a number of years). The individual investor may also obtain an apportioned share of the investment credit if the equipment is eligible for the credit and the lease is of a type which enables an individual investor to claim the credit.

Because of these tax advantages under prior law, when an investment was solicited in an equipment leasing venture, it was common practice to promise a prospective investor substantial tax losses which could be used to decrease the tax on his income from other sources. The Congress believed that is was not equitable to allow these individual investors to defer tax on income from other sources through the losses generated by equipment leasing transactions, to the extent the losses exceed the amount of his resources the investor has actually placed at risk in the transaction.

This leveraging of investments to produce tax savings in excess of amounts invested substantially alters the economic substance of the investment and distorts the workings of the investment markets. Taxpayers, ignoring the possible tax consequences in later years, can be led into investments which are otherwise economically unsound and which constitute an unproductive use of the taxpayer's (and the federal government's) investment funds. Because of these considerations, the Act applies the "at risk" rules to equipment leasing activities.

Explanation of provision

The Act provides that where an individual taxpayer may otherwise be entitled to deduct a loss in excess of his economic investment in an equipment leasing activity, the amount of the loss deduction is limited to the aggregate amount with respect to which the taxpayer is at risk in this trade or business at the close of the taxable year. This "at risk" limitation applies to all individual taxpayers who invest in an equipment leasing activity, including individuals who invest for their own account and those who do so through another entity such as a partnership, personal holding company, or subchapter S corporation. In addition, the limitation extends to trusts and estates, which are taxed like individuals. (For more detail as to the application and scope of the risk rule, see section 2, above.)

Under the at risk rule as it applies to equipment leasing, the taxpayer is considered to be in a leasing activity if he has an ownership interest, either direct or indirect, in section 1245 property (as defined in sec. 1245(a)(3)) which is leased or held for leasing.[3] In the case where equipment leasing activity is conducted by an individual, the at risk limitation applies separately to each property leased or held for leasing. (However, where several properties, such as parts of a computer, comprise one unit under the same lease agreement and are neither separately financed nor are subject to different lease terms, the properties are to be considered one property for purposes of the at risk rule.)

All equipment leasing activities engaged in through a partnership or subchapter S corporation will be treated as one activity under this provision. However, if the partnership or corporation engages in more than one type of activity covered by the at risk rule, then each type of activity is treated as a separate activity. For example, if a partnership has one farm and a number of equipment leasing transactions, it will be considered to have two activities, farming and equipment leasing,

[3] Since the at risk rule does not apply to real estate activities, in a situation where section 1245 property is leased as a minor incident of a lease of real property (such as where an unfurnished rental apartment is equipped with a stove or refrigerator), the at risk rules for equipment leasing will not be considered to apply.

and a separate application of the at risk limitation must be made for each of the two activities.

Effective date

The at risk rule for equipment leasing will apply generally to losses attributable to amounts paid or incurred (including depreciation or amortization allowed or allowable) after December 31, 1975. Special transitional rules are provided however for pre-existing leasing transactions.[4] In the case of leasing transactions where the property is leased under an operating lease, the at risk rule will not apply if the property was either subject to a binding lease before May 1, 1976 or subject to a binding purchase order by the lessor or lessee before this date. However, this grandfather rule will apply only to those taxpayers who owned their interests in the leased property on April 30, 1976.[5] The at risk rule will not apply to any type of leasing transaction where the property was either leased or ordered (by the lessor or lessee) before January 1, 1976, but only for those taxpayers who owned their interests in the property on December 31, 1975. In those situations where the eventual lessee has executed a binding purchase order for property by the relevant effective date and an investor has similarly acquired (or has irrevocably committed himself to acquire) an interest in the partnership or other entity which becomes the eventual lessor of the property by that date, the investor will be considered to have acquired an interest in the property for purposes of these transitional rules even though the assumption of the lessee's purchase order by the lessor entity actually occurs after the relevant date under these rules.

For purposes of these transitional rules, an order, a lease, and the acquisition of an interest in the property will not be considered to have occurred until they are evidenced by binding and legally enforceable agreements which are complete as to all relevant terms. However, a lease agreement will be considered binding on the relevant dates under the above provisions even though it is later modified to increase (but not decrease) the lease term.

Revenue effect

This provision will increase budget receipts by $4 million in fiscal year 1977, $14 million in fiscal year 1978, and $14 million in fiscal year 1981.

7. Sports Franchises and Player Contracts (sec. 212 of the Act and sec. 1245 and new sec. 1056 of the Code)

Prior law

Generally, the cost of tangible property used in a taxpayer's trade or business may be depreciated and deducted over the useful life of the property. In the case of a sports franchise, players' contracts (contracts for the services of athletes) are intangible assets and usually

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[4] These transitional rules in the Act erroneously refer to actilvties "described in [Code] section 465(c)(1)(B)", that is, farming activities. Congress intends, however, that these transitional rules apply to equipment leasing activities described in section 465(c)(1)(C).

[5] An operating lease for purposes of this transitional rule is defined in Code section 46(e)(3)(B) as generally one where the lease term is less than 50 percent of the property's useful life and the lessor's unreimbursed ordinary and necessary business deductions (under section 162) from the property are greater than 15 percent of its rental income during the first 12 months the property is held by the lessee.

represent one of the important costs incurred in connection with the acquisition of the franchise. It is the position of the IRS (as described below) that player contracts have a useful life of more than one year and therefore the cost of acquiring a player's contract is to be capitalized and depreciated over the life of the contract. While the terms of players' contracts vary with the type of sport involved, the typical contract will provide employment for one year and give the employer (the team) a unilateral option to renew the contract for an additional year at a specified percentage of the player's previous salary.[1]

In 1967, the Commissioner of Internal Revenue ruled that the cost of a player's contract must be capitalized and depreciated over the useful life of the contract. (Rev. Rul. 67–379, 1967–2 C.B. 127.) In adopting this position, the IRS noted that by reason of the reserve clause, a player contract has a useful life extending beyond the taxable year in which the contract was acquired. In Rev. Rul. 71–137, 1971–1 C.B. 104, the same result was reached with respect to football contracts by virtue of the option clause under the contract. Although the useful life varies from sport to sport, sports teams typically adopt a maximum life ranging between three and six years. The cost to be capitalized includes amounts paid or incurred upon purchase of a player contract and bonuses paid to players for signing contracts.

The depreciable basis of player contracts also affects the current capitalization and depreciation of bonus payments to be made in the future under the terms of the contract. Generally, an accrual basis taxpayer is entitled to deduct an unpaid expense for the taxable year in which all the events have occurred which determine the fact of liability and the amount can be determined with reasonable accuracy (Treas. Reg. § 1.461–1(a)(2)). Under this general rule, accrued salaries would ordinarily be deductible expenses for the taxable year in which earned by the employees even if paid in the following taxable year. However, any expenditure which results in the acquisition of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible for the taxable year in which the liability for the expenditure was incurred. This limitation would generally apply to amounts required to be capitalized with respect to a liability for future payments under a player contract.

In addition, another specific limitation would also apply in the case of such a contract if it is treated as a nonqualified deferred compensation plan. An employer is not entitled to deduct contributions made to or under a nonqualified deferred compensation plan, usually a trust, until the taxable year in which an amount attributable to the con-

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[1] Baseball and hockey contracts contain a specific "reserve clause" in which the right to renew the contract is itself renewed. Although the team obligates itself for only one year, the effect of this reserve clause in the contract, and certain league rules, is to bind the player to play only for the team which owns the contract. Under league rules, if the player refuses to sign a new contract or play for an additional year under the terms contained in the original contract, the team can prevent the player from playing for another team. Basketball and football player contracts purport to be less restrictive in that although they provide an option for an additional year's contract, they do not contain a reserve clause *per se*. Neither the contract nor the league rules prevent the player from "playing out his option" and becoming a "free agent." However, in the case of football, if a player becoming a free agent signs a contract with a different team in the NFL, then unless mutually satisfactory arrangements have been reached between the two league teams, the Commissioner of the NFL can assert the right to award to the former team one or more players (including future draft choices) of the acquiring team. This right is currently being litigated.

tribution is includible in the gross income of the employee. (sec. 404(a)(5)). The employee-beneficiary must generally include amounts paid on his behalf in his taxable year in which there is no substantial risk of forfeiture (secs. 83, 402(b), and 403(c)). In addition, the Internal Revenue Service has ruled that if compensation is paid by an employer directly to a former employee, under an unfunded plan, such amounts are deductible when *actually* paid in cash or other property (Rev. Rul. 60–31, 1960–1 C.B. 174). Thus, the deferred compensation rules would preclude the allowance of a deduction under an unfunded plan before the team makes the payment where the useful life of the player contract is shorter than the actual payout period.

When there is a sale or exchange of a sports franchise, both the buyer and the seller must generally make an allocation of the consideration for the sale or exchange between the various assets acquired or sold. Franchise rights are not usually depreciable because these rights exist for an unlimited period of time. Therefore, a purchaser of a sports team will benefit from larger depreciation deductions if he is able to allocate more of the aggregate purchase price to player contracts and less to franchise rights. Under prior law, there was no specific rule relating to the allocation of a portion of the total consideration paid to acquire a franchise, players' contracts and other assets which might be acquired at the time of acquisition of a franchise. Generally, this allocation was made on the basis of the fair market values (or relative fair market values) of the various assets. The allocation to players' contracts was also necessary when a new franchise is acquired through the expansion of an existing league or the formation of a new league.

Generally, depreciable property that is used in a trade or business is not treated as a capital asset. However (under section 1231), a taxpayer who sells property used in his trade or business benefits from special tax treatment. All gains and losses from section 1231 property are aggregated for the taxable year and any gain is treated as capital gain. If the losses exceed the gains, the loss is treated as an ordinary loss. Thus, gains from the sale of player contracts will be treated as capital gain and taxed at the more favorable long-term capital gain rates if the contracts were held for the requisite holding period, to the extent such gains are not "recaptured" as ordinary income under section 1245.[2]

Reasons for change

In many cases, the tax benefits which can be derived from investing in a sports franchise combine to transform an otherwise unprofitable investment into a very profitable one. In addition, the tax benefits to some extent may have increased the price of sports franchises.

One practice that increased the tax benefits resulting from the operation of a sports franchise was the allocation of a large part of the amount paid for the acquisition of a sports team to player contracts. Typically, a purchaser of a sports franchise attempted to allocate most of the aggregate purchase price of the franchise to player con-

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[2] The Internal Revenue Service has ruled that gains from the disposition of depreciable professional baseball and football player contracts which are owned by teams for more than 6 months are subject to recapture as ordinary income. [Rev. Rul. 67–380, 1967–2 C.B. 291 : Rev. Rul. 71–137, 1971–1 C.B. 104.]

tracts because the cost of a player contract could be depreciated over the life of the contract.[3] Amounts that were allocated to other assets such as the franchise rights or to good will could not be depreciated because these assets have an indeterminate useful life.

On the other hand, the seller attempted to allocate most of the aggregate sales price to franchise rights. In this way, a greater amount of any gain was treated as capital gain and a lesser amount was treated as gain attributable to depreciable assets (e.g., players' contracts) subject to recapture as ordinary income.

Since under prior law, depreciation with respect to player contracts was recaptured on a contract by contract basis, a substantial amount of depreciation allowed was not recaptured since many of the original players had retired or had been "cut" and replaced by new players. In addition, an abandonment loss is allowed for the adjusted basis of the player contract in the year a player retired or was cut. To the extent that gain attributable to player contracts was not recaptured, it can be argued that the taxpayer has converted an ordinary deduction into capital gain. Since the amount allocated to player contracts was usually a large portion of the acquisition cost of a sports franchise and may be depreciated over a short life, the amount allowed as a deduction in the early years in most cases was in excess of the income generated by the sports franchise for that year and produced a tax loss to shelter other income.

The Congress believed it was appropriate to deal directly with the tax treatment of player contracts in these cases since the concern has been with the allocation of basis to player contracts in the case of a sale or exchange of a sports franchise and the conversion of ordinary income into capital gain upon a subsequent sale. As a result, the Act in general provides that the purchase price allocated to player contracts by the purchaser cannot exceed the amount of the sales price allocated to those contracts by the seller. Also upon the subsequent sale of the franchise by the purchaser, the Act generally provides for the recapture of the depreciation taken (or any abandonment of losses) on the player contracts which were initially acquired with the original acquisition of the franchise by the seller.

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[3] Of the total cash consideration paid for an expansion major league football team, the Atlanta Falcons, the purchaser (a subchapter S corporation) treated $7,722,914 as the cost of player contracts and options, $727,086 as deferred interest and the remaining $50,000 as the cost of the franchise. This resulted in tax losses to the corporation of $506,329 in 1967 and $581,047 in 1968 which was passed through to the shareholders on a proportionate basis. Upon audit, the IRS determined that only $1,050,000 should be allocated to the player contracts and options, and $6,722,914 should be allocated to the nondepreciable cost of the National Football League franchise. The taxpayer paid the additional assessment, submitted a claim for refund, and after its disallowance, filed a suit for refund. The court rejected both the taxpayer's initial allocation of $7,722,914 and the Commissioner's allocation of $1,050,000 and concluded that the amount that should have been allocated to the players' contracts and options was $3,035,000. (*Laird* v. *U.S.*, 391 F. Supp. 656, 75–1 U.S.T.C. Par. 9274 (N.D. Ga. 1975)). The court further concluded that $4,277,043 represented the value of the television rights granted to the Atlanta Falcons under a 4-year contract between the NFL and the CBS television network and that this amount was not amortizable because the useful life of the television rights was for an indefinite period. The case is presently on appeal in the Fifth Circuit.

Questions have been raised as to the method used by the District Court in allocating the purchase price to the various assets acquired in the *Laird* case. Although the court held that the right to participate in receipts from television contracts could not be depreciated since it "had no definite limited useful life the duration of which could be ascertained with reasonable accuracy," the court relied upon the existing 4-year contract in valuing this right for purposes of allocating the purchase price. Concern has been expressed as to whether, if the television contract had only 1 year left at the time of acquisition, the court would have determined the contract's value to be the present value of the right to receive television receipts for only 1 year.

Explanation of provision

The Act provides that in the case of the sale, exchange, or other disposition of a sports franchise (or the creation of a new franchise), the amount of consideration allocated to a player contract by the transferee shall not exceed the sum of the adjusted basis of the contract in the hands of the transferor immediately before the transfer and the gain (if any) recognized by the transferor on the transfer of the player contract. In this way, a more appropriate allocation will be achieved since, to a substantial extent the buyer and seller will be adverse parties with respect to the allocation (i.e., to the extent that the amount of gain attributable to player contracts will be fully recaptured as ordinary income, the buyer and seller will be operating at arms-length with respect to the allocation). This limitation is not to apply to a like-kind exchange under section 1031 of the code. In addition, the provision is not to apply with respect to the determination of basis of the player contract in the hands of a person acquiring the contract from a decedent.

Under this provision, the transferor must provide both the Secretary and transferee with information stating the amount which the transferor believes to be the adjusted basis in the player contract, the amount which the transferor believes to be the gain (if any) recognized on the transfer of the player contract and any subsequent modification to either amount. The time and manner for furnishing this information is to be provided by regulations prescribed by the Secretary. Further, these amounts are to be binding on both the transferor and the transferee to the extent provided in such regulations.

The Act also provides that in the case of the sale or exchange of a sports franchise, it is presumed that not more than 50 percent of the consideration is allocable to player contracts unless the taxpayer can satisfy the Secretary of the Treasury that under the facts and circumstances of the particular case, it is proper to allocate an amount in excess of 50 percent. However, the Act provides that the presumption does not mean that an allocation of less than 50 percent of the consideration to player contracts is proper. The proper allocation is to depend upon the facts and circumstances of each particular case. Factors to be taken into account by the Secretary are to include the amount of gate receipts received by the past owner of the franchise (as well as the amount expected to be received in the future), the amount of radio and television receipts that were received by the past owner of the franchise (as well as the amount expected to be received in the future), etc. It is recognized that there are differences among the various sports which are relevant to the proper allocation and, therefore it is intended that factors peculiar to each sport (and to each team) be taken into account. For example, in the case of baseball, revenues from television and radio contracts are to a substantial degree derived from individual team contracts rather than, as in the case of football, from league contracts.

The Act provides special rules for the recapture of depreciation and deductions for losses taken with respect to player contracts. The special recapture rules apply only in the case of the sale, exchange, or other disposition (other than a disposition under which the transferee has a carry-over basis) of the entire sports franchise. In the case of the sale or exchange of individual player contracts recapture will continue to be determined on a contract-by-contract basis. Under these special rules, to the extent of any gain attributable to player contracts, the amount recaptured as ordinary income will be the greater of (1) the sum of the depreciation taken plus any deductions taken for losses (i.e., abandonment losses) with respect to those player contracts which are initially acquired as a part of the original acquisition of the franchise or (2) the amount of depreciation taken with respect to those player contracts which are owned by the seller at the time of the sale of the sports franchise. To the extent that depreciation taken on player contracts which were acquired as part of the original acquisition of the franchise has previously been recaptured, the amount so recaptured will reduce the aggregate amount of depreciation and losses attributable to player contracts initially acquired for purposes of determining the recapture amount under (1) above. The amount determined under (2) above with respect to player contracts held at the time the franchise is sold will be equal to the aggregate depreciation allowed or allowable for all such contracts. Thus, the amount subject to recapture will be determined for player contracts on a consolidated basis and may exceed the sum of the amounts which would otherwise be subject to recapture if determined on a contract-by-contract basis, e.g., the aggregate gain is equal to or greater than the aggregate depreciation deductions, but the gain attributable to one or more of the contracts is less than the applicable depreciation.

Effective dates

The provision relating to the allocation of basis to player contracts applies to sales or exchanges of franchises after December 31, 1975, in taxable years ending after that date. The provision relating to the recapture of depreciation applies to transfers of player contracts in connection with any sale or exchange of a franchise after December 31, 1975.

Revenue effect

It is estimated that the provision relating to allocation of basis to player contracts will result in a revenue gain of $1 million for fiscal year 1977, and $8 million for fiscal year 1981. In addition, it is estimated that the provision relating to depreciation recapture will result in a revenue gain of $7 million for fiscal year 1977 and 1981.

8. Partnership Provisions

a. Partnership Additional First-Year Depreciation (sec. 213(a) of the Act and sec. 179(d) of the Code)

Prior law

An owner of tangible personal property is eligible to elect, for the first year the property is depreciated, a deduction for additional first-year depreciation of 20 percent of the cost of the property (sec. 179). The cost of the property on which this "bonus" depreciation is calculated is not to exceed $10,000 ($20,000 for an individual who files a joint return). The maximum bonus depreciation deduction is thus limited to $2,000 ($4,000 for an individual filing a joint return). Bonus depreciation is available only for property that has a useful life of six years or more.

Where the owner is a partnership, the election for bonus depreciation is made by partnership. However, under prior law, the dollar limitation described above was applied to the individual partners rather than to the partnership entity. For example, each one of 40 individual investors who contributed $5,000 to an equipment leasing limited partnership, which purchased a $1 million executive aircraft, would have been entitled to $4,000 of bonus depreciation if he filed a joint return. In this case, additional first-year depreciation would have provided total deductions to the partners of up to $160,000.

A corporation, however, under present law, is allowed to deduct only $2,000 of additional first-year depreciation. Thus, in the case of the purchase of an aircraft, as described above, a corporation would be limited to $2,000 of additional first-year depreciation, whereas the partnership, under prior law, could have passed through to the partners total first-year additional depreciation of up to $160,000.

Reasons for change

Allowing each individual partner in a partnership to have the full $2,000 first-year depreciation deduction (or $4,000, in the case of a married partner filing a joint return) inflates the amount of "bonus depreciation" which should be allowable in the year the property is placed in service.

The provision for bonus depreciation (sec. 179) was enacted to provide a special incentive for small businesses to make investments in depreciable property. The limitations on the dollar amount of property with respect to which a taxpayer can take additional first-year depreciation were intended to insure that this provision allow only a very limited dollar benefit to any enterprise, regardless of size. The dollar limitation was thus intended to insure that the allowance for additional first-year depreciation would be of significance primarily for small businesses. In practice, however, the lack of a dollar limitation on the amount of depreciable basis with respect to which a partnership could calculate the bonus depreciation—even though there is a dollar limitation which applies to each partner—had enabled partnerships with many partners, especially tax-shelter partnerships, to pass through amounts of bonus depreciation very substantially in excess of what was intended to be allowed.

Explanation of provision

The Act provides that, with respect to a partnership, the dollar limitation is first applied at the partnership level. Thus, the cost of the property on which additional first-year depreciation is calculated for the partnership as a whole is not to exceed $10,000. However, this provision does not affect the dollar limitation which is applicable to the individual partners. Thus, for example, if a single individual is a member of a partnership and also owns a sole proprietorship, the total amount of the cost basis of property on which he can calculate additional first-year depreciation is $10,000.

Effective date

This provision is effective for partnership taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that this provision and the three following partnership provisions will result in an increase in budget receipts of $12 million in fiscal year 1977 and $10 million annually thereafter.

b. Partnership Syndication and Organization Fees (sec. 213(b) of the Act and secs. 707(c) and 709 of the Code)

Prior law

Prior law (sec. 707(c)) provided for the deduction by a partnership of so-called "guaranteed payments" made to a partner for services or for the use of capital to the extent the payments were determined without regard to the income of a partnership, "but only for the purposes of section 61(a) (relating to gross income) and section 162 (a) (relating to trade or business expenses)." However, present law (sec. 263) generally provides that no current deduction shall be allowed for capital expenditures. Nonetheless, it has been contended that these payments under section 707(c) were automatically deductible by the partnership without regard to the "ordinary and necessary" requirements of section 162(a) or section 263.

Thus, until recently, it has been the common practice for limited partnerships to deduct the payments made to the general partner for the services he rendered in connection with the syndication and organization of the limited partnership. However, in recently issued Rev. Rul. 75–214 (1975–1 C.B. 185), the Internal Revenue Service ruled that payments made by a partnership to a general partner to reimburse him for costs of organizing the partnership and for selling the limited partnership interests were not automatically deductible by virtue of section 707(c), but rather were capital expenditures under section 263. The ruling stated that: "For purposes of either section 707(a) or section 707(c) of the Code, payments to partners for services on behalf of the partnership may be deducted by the partnership only if such payments would otherwise be deductible (under section 162) if they had been made to persons who are not members of the partnership."

Similarly, the Tax Court, in *Jackson E. Cagle, Jr.*, 63 T.C. 86 (1974) *aff'd*, 539 F. 2d 409 (5th Cir. 1976), disallowed deductions for partners' shares of payments made by a partnership to another partner for services rendered in conducting a feasibility study of a proposed office-showroom facility, obtaining financing, and developing a building for the partnership. In this decision, the Tax Court expressly rejected the contention that Congress, in enacting section 707(c), had intended to make guaranteed payments to partners automatically deductible to the partnership without regard to sections 162(a) and 263.

Reasons for change

The correct interpretation of section 707(c) is the interpretation given that subsection by the Internal Revenue Service and the Tax

Court, as discussed above. However, despite this court decision and Revenue Ruling, prior law was not entirely clear that, to be deductible, guaranteed payments must meet the same tests under section 162(a) as if the payments had been made to a person who is not a member of the partnership. A contrary conclusion would allow partnerships to treat capital expenditures as current deductions, while a corporation incurring these expenditures would not be entitled to similar treatment.

While section 263 requires these expenditures of a corporation to be capitalized, section 248 allows the corporation to elect to amortize the organizational expenditures (as opposed to syndication-type expenditures) over a period of not less than 60 months. Under the regulations, the costs incurred by a corporation in marketing and issuing its stock are capital expenditures under section 263, but are not subject to the 60-month amortization provisions of section 248. (Regs. § 1.248-1(b)(3)(i)[1]

Explanation of provisions

The Act adds a new provision (sec. 709) which provides that, subject to the special amortization provision described below, no deduction shall be allowed to a partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale (or to sell) an interest in the partnership. The Act also amends section 707(c) to make it clear that, in determining whether a guaranteed payment is deductible by the partnership, it must meet the same tests under section 162(a), as if the payment had been made to a person who is not a member of the partnership, and the normal rules of section 263 (relating to capital expenditures) must be taken into account.[2]

The Act provides that a partnership may elect to deduct ratably, over a period of not less than 60 months, amounts paid or incurred in organizing the partnership.[3] The organizational expenses subject to the 60-month amortization provision are defined as those expenditures which are incident to the creation of the partnership, chargeable to the capital account, and of a character which, if expended in connection with the creation of a partnership having an ascertainable life, would be amortized over that period of time.

The capitalized syndication fees, i.e., the expenditures connected with the issuing and marketing of interests in the partnership, such as commissions, professional fees, and printing costs, are not to be subject to the special 60-month amortization provision.

Effective date

The provisions relating to guaranteed payments and the capitalization of partnership syndication and organization fees apply to taxable years beginning after December 31, 1975. The provision pertaining to the amortization of organization fees applies to amounts paid or in-

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[1] For cases supporting this position, see *Davis* v. *Commissioner*, 151 F. 2d 441 (8th Cir. 1945), *cert. den.*, 327 U.S. 783; *United Carbon Company*, 32 B.T.A. 1000 (1935).

[2] The Act is not intended to adversely affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest.

[3] If the partnership were liquidated before the end of the 60-month period, the remaining organizational expenses would be deductible to the extent provided under the provision relating to losses (sec. 165).

curred in partnership taxable years beginning after December 31, 1976.

Revenue effect

The revenue impact of these provisions is included in the estimate under *a* above.

c. Retroactive Allocations of Partnership Income or Loss (sec. 213(c) of the bill and secs. 704(a) and 706(c) of the Code)

Prior law

Investments in tax shelter limited partnerships have commonly been made toward the end of the taxable year. It has also been common for the limited partnership to have been formed earlier in the year on a skeletal basis with one general partner and a so-called "dummy" limited partner. In many cases, the limited partnerships incurs substantial deductible expenses prior to the year-end entry of the limited partner-investors.

In these cases, a full share of the partnership losses for the entire year had usually been allocated to those limited partners joining at the close of the year. These are referred to as "retroactive allocations." For example, in the case of a limited partnership owning an apartment house which had been under construction for a substantial part of the year, where construction interest and certain deductible taxes had been paid during that time, such deductions might have been retroactively allocated to investors entering the partnership on, say, December 28th of that year.

Prior law was not clear whether retroactive allocations were permissible under the Code.[4] Essentially, there are four partnership Code provisions which had a direct or indirect bearing on this issue—sections 704(a), 761(c), 704(b)(2) and 706(c)(2)(B).

Section 704(a) of prior law provided, in effect, that except as otherwise provided in section 704, the partnership agreement would govern the manner of allocation of "income, gain, loss, deduction, or credit." With respect to a particular taxable year, section 761(c) of present law treats a partnership agreement as consisting of any amendment made up to and including the time for which the partnership's tax return must be filed for such year. It was argued that sections 704(a) and 761(c), particularly when read together, allowed retroactive allocations. On the other hand, it was argued that sections 704(b)(2) and/or 706(c)(2)(B) of prior law, discussed below, prohibited some or all retroactive allocations.

Section 704(b)(2) prohibited the allocation of items of income, deduction, loss or credit (such as capital gains and depreciation) where the principal purpose of the allocation was the avoidance or evasion of tax. This provision, it was argued, prohibited any retroactive allocation having tax avoidance as its principal purpose. The counter-argument to this claim was that section 704(b)(2) was inapplicable to retroactive allocations of taxable income and loss, since, by its own terms,

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[4] Two primary cases dealing with the issue of retroactive allocations are *Smith* v. *Commissioner*, 331 F. 2d 298 (7th Cir. 1964), and *Rodman* v. *Commissioner*, — F. 2d — (2d Cir. 1976) [CCH U.S. Tax Cases, ¶ No. 9710], reversing and remanding 32 T.C.M. 1307 (1973).

it only pertained to allocations of particular *items* of income, deduction, loss, or credit.[5]

Section 706(c)(2)(B) provides that where a partner disposes of less than his entire interest in a partnership, or his interest is reduced, the partnership taxable year does not close as to such partner, but that his distributive share of partnership income and loss is determined "by taking into account his varying interests in the partnership during the taxable year." While not specifically stated in this provision or the relevant regulations (Regs. § 1.706–1(c)(4)), it is implicit that the transferee of less than the entire interest of a transferor-partner would necessarily be subject to the same rule, i.e., his distributive share of partnership income and loss would be determined by taking into account his varying interests in the partnership during the taxable year. For example, if, on July 1, a person, who was not previously a partner, were to acquire from an existing partner a 25 percent interest in a calendar year reporting partnership, which had a loss for the year of $1,000, then, by taking into account his varying interests of zero during the first half of the year and 25 percent during the second half, $125 of the loss would be allocable to the transferee-partner under section 706(c)(2)(B).

As previously stated, section 706(c)(2)(B) also applies where the interest of a partner is reduced. Under prior law, it was unclear whether this provision pertained to the situation where a partner's proportionate interest in the partnership was reduced as the result of the purchase of an interest directly from the partnership. Consequently, it was unclear whether an incoming partner, who purchased his interest directly from the partnership, would be subject to the rule of including partnership income and loss according to his varying interests during the year. Some argued that the varying interests rule of section 706(c)(2)(B) was inapplicable to this situation.

It was further argued that, even if section 706(c)(2)(B) imposed the varying interests rule in the above situation, a timely amendment to the partnership agreement providing for a retroactive allocation of the entire year's losses would, pursuant to sections 704(a) and 761(c), override this provision.

Section 706(c)(2(A) of present law provides that where a partner retires or sells his entire interest in a partnership, the taxable year of the partnership will close and the partner's distributive share of various income and deduction items will be determined under the income tax regulations. Essentially, the regulations (Regs. § 1.706–1(c)(2)(ii)) provide the alternatives of either an interim closing of the partnership books or the determination of a partner's distributive share of income and deductions by a proration of such items for the taxable year, the proration being based either upon the portion of the taxable

[5] The main case dealing with the interpretation of section 704(b)(2) with respect to this issue is *Jean V. Kresser*, 54 T.C. 1621 (1970). In *Kresser,* the retroactive allocation involved was disallowed upon the court's findings that the partnership agreement was not amended to provide for the allocation and the allocation of income was, in fact, nothing more than a paper transaction lacking in economic substance. One of the arguments of the Government was that section 704(b)(2) precluded the retroactive allocation. The court dealt with this contention in a footnote (*supra,* at p. 1631), which indicated support for the interpretation of section 704(b)(2) as applying only to allocations of particular items of income, deductions, or credit, and not to allocations of the composite of the partnership's income or loss. However, because of the court's initial findings (i.e., the absence of both an amendment to the partnership agreement and a bona fide reallocation of income), it did not resolve this issue.

year that had elapsed prior to the sale or retirement or under any other method that is reasonable. These alternative methods of computation were not specifically provided, however, with respect to the sale or exchange of, or a reduction in, a partnership interest under section 706(c)(2)(B). As previously mentioned, in cases to which section 706(c)(2)(B) applied, the only guidance provided was that income and loss allocations should take into account a partner's "varying interests in the partnership during the taxable year."

Reasons for change

Under prior law, it was unclear whether section 706(c)(2)(B) required the inclusion of income and loss according to a partner's varying interests during the year where the partner's interest was acquired directly from the partnership. Even if section 706(c)(2)(B) imposed the varying interests rule in this situation, there was the further ambiguity whether a retroactive allocation provided in a partnership agreement would, under the authority of sections 704(a) and 761(c), override any allocation provided under section 706(c)(2)(B). Moreover, even if it were established that section 706(c)(2)(B) was not overridden by a retroactive allocation pursuant to sections 704(a) and 761(c), no clear method was provided in the Code or regulations for taking into account the varying interests of the partners during the partnership year.

In essence, the consequence of allowing retroactive allocations was that new partners investing in the partnership toward the close of the taxable year were allowed to deduct expenses which were incurred prior to their entry into the partnership. Some argued that these retroactive allocations were proper because the funds invested by the new partners served to reimburse the original partners for their expenditures and that, as an economic matter, the new partners had incurred the costs for which they were claiming deductions. However, this argument loses its persuasiveness when the new partner in a partnership situation is compared to that of an investor who directly purchases property which had previously generated tax losses during the taxable year. It is clear that in the latter case the investor would not be entitled to deduct the losses incurred prior to his ownership of the property, notwithstanding the fact that he, in effect, may be reimbursing the seller of the property for losses already incurred.

In order to deal with the problem of retroactive allocations and clarify the treatment of a partner's interest where the partner acquired the interest directly from the partnership, the Act specifically provides that the present varying interests rule is to apply to a partner's interest acquired directly from the partnership.

Explanation of provision

The Act amends section 706(c)(2)(B) to make it clear that the varying interests rule of this provision is to apply to any partner whose interest in a partnership is reduced, whether by entry of a new partner who purchased his interest directly from the partnership, partial liquidation of a partner's interest, gift, or otherwise. Correspondingly, the provision is to apply to the incoming partner so as to take into account his varying interests during the year. In addition, regulations are to apply the same alternative methods of computing allocations of income and loss to situations falling under section 706(c)(2)(B) as those now applicable to section 706(c)(2)(A) situations (sale or liquidation of an entire interest). As under section 706(c)(2)(A), these rules will permit a partnership to choose (1) the easier method of prorating items either according to the portion of the year for which a partner was a partner or under any other method that is reasonable or (2) an interim closing of books (as if the year had closed). However, any proration or interim closing of the books under section 706(c)(2)(B), unlike that under section 706(c)(2)(A), would not result in the actual closing of the partnership taxable year.

The interim closing of the books or proration is to relate to the time of the reduction (and corresponding increase) in partnership interest. To alleviate the undue accounting complexity that may result with respect to reductions in interest occurring over several days in the same month, the regulations may provide, for example, that the interim closing of the books could relate to the fifteenth and last day of each month. Thus, an interim closing of the books as of the close of December 15th would be sufficient, for example, with respect to new partners entering on the 16th, 19th, 20th, and 21st of December.

In addition, section 704(a) (relating to the effect of a partnership agreement) is amended to provide that it is overridden by any contrary income tax provisions of the Code. Thus, a partnership agreement, amended (pursuant to section 761(c)) to provide for a retroactive allocation, will not override an allocation required under section 706(c)(2)(B).

Effective date

These provisions are effective for partnership taxable years that begin after December 31, 1975. The Congress does not intend that any inference be drawn as to the propriety or impropriety of a retroactive allocation under prior law.

Revenue effect

The revenue impact of this provision is included in the revenue estimate under *a* above.

d. Partnership Special Allocations (sec. 213(d) of the Act and sec. 704(b) of the Code)

Prior law

A limited (or a general) partnership agreement may allocate income, gain, loss, deduction, or credit (or items thereof) among the partners in a manner that is disproportionate to the capital contributions of the partners. These are sometimes referred to as "special allocations" and, with respect to any taxable year, may be made by amendment to the partnership agreement at any time up to the initial due date of the partnership tax return for that year (sec. 761(c)).

A special allocation was not recognized under prior law (sec. 704(b)(2)) if its principal purpose was to avoid or evade a Federal tax. In determining whether a special allocation had been made principally for the avoidance of tax, the regulations focused upon whether the special allocation had "substantial economic effect," that is, whether the allocation may actually affect the dollar amount of the partner's share of the total partnership income or loss independently of tax consequences (Regs. § 1.704–1(b)(2)). The regulations also inquired as to whether there was a business purpose for this special allocation, whether related items from the same source were subject to the same allocation, whether the allocation ignored normal business factors and was made after the amount of the specially allocated item could reasonably be estimated, the duration of the allocation, and the overall tax consequences of the allocation.

By its terms, the tax avoidance provisions of prior law section 704(b)(2) applied to allocations of *items* of income, gain, loss, deduction, or credit. It was thus argued that these provisions did not apply to and would not preclude allocations of taxable income or loss, as opposed to specific items of income, gain, deduction, loss, or credit.

The main case dealing with the interpretation of section 704(b)(2) with respect to this issue is *Jean V. Kresser*, 54 T.C. 1621 (1970). In *Kresser*, a purported allocation of all a partnership's taxable income for one taxable year to one partner who had a net operating loss carryforward expiring in that year was disallowed upon the court's findings that the partnership agreement was not amended to provide for the allocation and the allocation of income was, in fact, nothing more than a paper transaction lacking in economic substance. One of the arguments of the Government was that section 704(b)(2) precluded the allocation. The court dealt with this contention in a footnote (*supra*, at p. 1631), which indicated support for the interpretation of section 704(b)(2) as applying only to allocations of particular items of income, deduction, or credit, and not to allocations of the composite of the partnership's income or loss. However, because of the court's initial findings (i.e., the absence of both an amendment to the partnership agreement and a bona fide reallocation of income), it did not resolve this issue.

Reasons for change

Congress believed that an overall allocation of the taxable income or loss for a taxable year (described under section 702(a)(9)) should be subject to disallowance in the same manner as allocations of items of income or loss.

Also, allocations of special items and overall allocations should be restricted to those situations where the allocations have substantial economic effect.

Explanation of provisions

The Act provides that an allocation of overall income or loss (described under section 702(a)(9)), or of any item of income, gain, loss, deduction, or credit (described under section 702(a) (1)–(8)), shall be controlled by the partnership agreement if the partner receiving the allocation can demonstrate that it has "substantial economic effect", i.e., whether the allocation may actually affect the dollar amount of the partners' share of the total partnership income or loss, independent of tax consequences.[6] Other factors that could possibly relate to

[6] The determination of whether an allocation may actually affect the dollar amount of the partners' shares of total partnership income or loss, independent of tax consequences, will to a substantial extent involve an examination of how these allocations are treated in the partners' capital accounts for financial (as opposed to tax) accounting purposes; this assumes that these accounts actually reflect the dollar amounts that the partners would have the rights to receive upon the liquidation of the partnership.

the determination of the validity of an allocation are set forth under the present regulations (Regs. § 1.704–1(b)(2)).

If an allocation made by the partnership is set aside, a partner's share of the income, gain, loss, deduction or credit (or item thereof) will be determined in accordance with his interest in the partnership.

In determining a "partner's interest in the partnership", all the relevant facts and circumstances are to be taken into account. Among the relevant factors to be taken into account are the interest of the respective partners in profits and losses (if different from that in taxable income or loss), cash flow, and their rights to distributions of capital upon liquidation.

Effective date

The provision applies to partnership taxable years beginning after December 31, 1975. No inference is to be drawn as to the propriety or impropriety of a special allocation under prior law.

Revenue effect

The revenue impact of this provision is included in the revenue estimate under *a* above.

e. Treatment of Partnership Liabilities Where a Partner Is Not Personally Liable (sec. 213(e) of the Act and sec. 704(d) of the Code)

Prior law

Under both prior and present law, a partner may deduct his distributive share of all the deductible items of the partnership, but not more than the amount of the adjusted basis of his interest in the partnership (sec. 704(d)). Under the income tax regulations, a partner's adjusted basis in his partnership interest is increased by a portion of any partnership liability with respect to which there is no personal liability on the part of any of the partners (Treas. Reg. § 1.752–1(e)).

Reasons for change

Under prior law, a partner was allowed to substantially increase the adjusted basis in his partnership interest, and thus the amount of partnership losses he could deduct, by a portion of the partnership liabilities with respect to which he had no personal liability. This rule enabled partners to deduct amounts for tax purposes exceeding the amount of investment that they had economically at risk in the partnership.

Explanation of provision

The Act amends section 704(d) by providing that, for purposes of the limitation on allowance of partnership losses, the adjusted basis of a partner's interest will not include any portion of any partnership liability with respect to which the partner has no personal liability.

It is intended that in determining whether a partner has personal liability with respect to any partnership liability, rules similar to the rules of section 465 (relating to the limitation on deductions to amounts at risk in case of certain activities) will apply. Thus, for example, guarantees and similar arrangements may be taken into account in determining whether there is personal liability.

This provision will not apply to the extent that a partnership activity is subject to the provisions of section 465 (relating to the limitation on deductions to amounts at risk in case of certain activities) nor will it apply to any partnership the principal activities of which involve real property (other than mineral property).[7]

This provision will not apply to a corporate partner (other than a subchapter S corporation or a personal holding company) with respect to liabilities incurred in an activity to the extent that the activity is subject to the provisions of section 465. Thus, if two corporations form a partnership for an equipment leasing activity, this provision will not apply; but, if in addition to equipment leasing, the partnership invests in an activity not specified under section 465 and which does not involve real property (other than mineral property), then this provision will apply to the extent of liabilities incurred wtih respect to that other activity.

It is contemplated that this provision and the specific at-risk rules of section 465 could apply to a partnership carrying on more than one activity. For example, a partnership involved in equipment leasing to which the at-risk provisions of section 465 would apply, may also be indebted on a nonrecourse basis with respect to activities which are unrelated to the equipment leasing activity of the partnership. In this instance, separate computations for purposes of allowance of losses would have to be made under both sections 465 and 704(d).

Also, for example, if a partnership engages in the raising of trees, some of which bear fruit and nuts, this provision will not apply to the extent that the tree-raising activity is subject to the provisions of section 465.

Effective date

This provision applies to liabilities incurred after December 31, 1976.

Revenue effect

The revenue impact of this provision is included in the revenue estimate under a. above.

9. Interest

a. Treatment of Prepaid Interest (sec. 208 of the act and sec. 461(g) of the Code))

Prior law

A taxpayer may generally claim deductions in the year which is proper under the method of accounting which he uses in computing his taxable income (sec. 461). Under prior law, a taxpayer using the cash receipts and disbursements method of accounting has generally been able to claim a deduction for interest paid within his taxable year (sec. 163(a)). However, if the taxpayer's method of accounting does not clearly reflect income, the Internal Revenue

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[7] Generally, the principal activities of a partnership would involve real property if substantially all of its activities involve the holding of real property for sale, for investment, or for deriving rental-type income. The holding of real property for sale, for investment, or for deriving rental-type income would include the investment in a partnership or joint venture where substantially all of the activities of the partnership or joint venture involve the holding of real property for sale, for investment, or for deriving rental-type income.

Service may recompute the income using the method which the Service believes clearly reflects income (sec. 446(b)). The income tax regulations also provide that, even under the cash method of accounting, an expense which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may be deducted only in part in the year in which payment is made.

No specific statutory provision has expressly permitted prepaid interest to be deducted in full when paid by a cash method taxpayer. The authority for deducting prepaid interest rested on court cases and on administrative rulings by the Service. Until the late 1960's, tax-oriented investors were able to prepay as much as five years' interest with apparent approval by the courts and the Service.

In 1968, however, the Service published a revenue ruling holding that an interest prepayment by a cash-basis taxpayer for a period extending for more than 12 months beyond the end of the current taxable year would be deemed to create a material distortion of income. In such a case the interest would be allocated over the taxable years involved. Deductions for interest paid in advance for a period not in excess of 12 months after the last day of the taxable year of payment were considered on a case-by-case basis to determine whether a material distortion of income resulted.[1] Recent Tax Court cases have disallowed prepaid interest deductions of taxpayers in situations where the Internal Revenue Service has relied on this ruling as authority to disallow the deduction. The Tax Court has indicated, however, that under prior law it might not be willing to disallow prepaid interest in all cases where the prepayment relates to periods extending more than 12 months beyond the end of the current taxable year.

The tax treatment of a loan requiring prepaid interest or points has contrasted with the tax treatment of a discount loan under present law, although in many situations the economic substance of both transactions is similar. In a discount loan, the lender delivers to the borrower an amount which is smaller than the face amount of the loan. The difference between the face amount and the amount delivered to the borrower is the charge for his use of the borrowed funds. Under prior law, a borrower on the cash method could not deduct the entire interest element in the year in which he received the loan proceeds. He could deduct the interest element only when and as he actually repaid the face amount of the loan.[2]

Reasons for change

Prepaid interest has been extensively used in many types of tax shelters to defer tax on income which would otherwise be taxable in higher marginal tax brackets. The deduction for prepaid interest has become highly important to investors seeking year-end tax losses who acquire their interests in a property (such as land, an apartment building, cattle, computers, motion pictures and the like), or in a

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[1] The ruling (Rev. Rul. 68-643, 1968-2 C.B. 76) sets forth several factors which may be considered in determining whether there is a material distortion of income: the amount of the taxpayer's income in the taxable year of payment; his income in previous years; the amount of prepaid interest; the time of payment; the reason for the prepayment; and the presence of a varying rate of interest over the term of the loan.

[2] See Rev. Rul. 75-12, 1975-1 C.B. 62.

partnership which will own the property, toward the end of the calendar year. In such cases, the investors may not have been able to operate the property long enough in that taxable year to generate either income or a large amount of ordinary and necessary business expenses. Therefore, deductions arising from prepaying as much of the financing costs as possible have been central to the creation of year-end tax losses. If the investors had income from other sources, the interest deductions were used to offset this other income (rather than offsetting income from the property itself, which would be realized in a later year). Prepaid interest thus has given a taxpayer the time value of deferring taxes on his other sources of income.[3]

The advantages of prepaying interest have been especially attractive to persons who have unusually high income in a particular year and who are in a higher effective tax bracket that year than they expect to be in during later years.

In many cases a deduction for prepaid interest was generated without adverse cash flow consequences by borrowing more than was needed and promptly repaying the excess as "prepaid interest."[4]

A recent technique used to justify larger amounts of prepaid interest within the Service's present guidelines than could be obtained under conventional financing is the "wraparound" mortgage (sometimes referred to as an all-inclusive deed of trust). Often, a farm, shopping center or other property which investors are purchasing is encumbered by an existing first mortgage. In a situation involving a wraparound mortgage, the investors would execute to the seller a new purchase money obligation whose face amount included both the unpaid balance of the first mortgage and the new financing supplied by the seller (which would ordinarily take the form of a second mortgage). The buyers would agree to pay (and to prepay) interest on the face amount of the "wraparound" note, while the seller would agree to continue paying the interest on the first mortgage out of the interest payments which he would receive from the buyers. Since a wraparound mortgage usually bears a higher rate of interest than the first mortgage (and in some cases the additional prepaid interest which the buyers have claimed on the note has been negotiated as a substitute for a larger downpayment), this type of arrangement has been widely used to increase the amount of interest which could be prepaid in the initial year of a purchase of property and claimed as a deduction for one year's prepaid interest within the Service's guidelines.[5]

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[3] In some cases the investors (or their partnership) execute a purchase money mortgage note to the person who is selling the property to them. Although most sellers would ordinarily desire to receive a larger purchase price (capital gain) and less interest (ordinary income), many sellers are not adversely affected by receiving ordinary income. Some sellers may have expiring loss carryovers to absorb the interest income. Others are dealers who would realize ordinary income on the sale in any event; other sellers are pension funds, charities or other tax-exempt organizations.

[4] In some cases an interest prepayment reduces the taxpayer's cash flow (net of tax savings). However, as long as the deduction lowers the taxpayer's effective tax rate by more than the market rate of interest which he could earn on the cash he invests, the taxpayer will find it to his advantage to shelter his income by prepaying interest. (Generally, the largest reductions in effective tax rate will accrue to taxpayers in the higher marginal tax brackets.)

[5] The seller of property has been motivated to use a wraparound mortgage because he is relending the balance of the first mortgage to the investor at a higher rate of interest than he pays to his lender. Thus, the amount received as a result of the difference between the interest rates is additional profit to him.

A wraparound mortgage is also often used as a refinancing device by an owner of mortgaged property who desires to receive a new loan from a third party, who agrees to pay off the existing lien out of the payments which he receives from the borrower.

Congress believed that the creation of a tax shelter with prepaid interest could not be justified even under the cash method of accounting. The policies underlying the cash method, namely, simplicity and avoidance of complex recordkeeping or computations, do not apply to prepaid interest, which can be allocated over the term of a loan.

Under prior law there has been considerable uncertainty as to the deductibility of prepaid interest. Under the Tax Court's holdings, the deductibility of prepaid interest depends on a case-by-case determination. Even under the Internal Revenue Service position, a case-by-case determination must be made in all cases where interest is prepaid for a period which does not extend more than 12 months beyond the taxable year in which the prepayment is made. Consequently, a deduction of prepaid interest by the same taxpayer might have been allowed in one year and perhaps not in another year. Also, prepaid interest might have been deductible by one taxpayer who has a large amount of income in a given year after the deduction (so that the deduction arguably has not "distorted" his income) but possibly not have been deductible by another taxpayer who had little or no taxable income after taking the deduction. In the case of prepaid interest, the clear reflection of income test should focus less on comparing the interest deduction with the taxpayer's general income stream from year to year than on matching interest and other costs of carrying a particular property against its income or loss over the term of the loan.

Explanation of provision

The Act permits a cash method taxpayer to deduct prepaid interest no earlier than in the taxable year in which (and to the extent that) the interest represents a charge for the use or forbearance of borrowed money during that period.

Under this provision, if a taxpayer uses the cash receipts and disbursements method to compute his taxable income, interest which he pays and which is properly allocable to any later taxable year must be charged to capital account and treated as paid by him in the periods in which (and to the extent that) the interest represents a charge for the use or forbearance of borrowed money during each such taxable year. In determining whether an interest prepayment is properly allocable to one or more taxable years after the year of payment, the allocation is to be made to the period or periods in which the interest represents a cost of using the borrowed money in that period, regardless of whether allowing prepaid interest to be deducted when paid would materially distort the taxpayer's income in the year of payment (or the income of a partnership of which the taxpayer may be a member).

This rule applies to all types of taxpayers, including individuals, corporations, estates and trusts and covers interest paid for personal, business or investment purposes.

The new statutory rule relates to interest prepayments by a cash method taxpayer. It is intended to conform the tax deductibility of prepaid interest by cash method taxpayers to the rule which Congress understands to be proper under prior law for interest prepayments by an accrual method taxpayer.[6]

Once prepaid interest has been allocated to the proper periods, the interest allocable to a given taxable year will then become subject to other limitations. For example, interest allocated to a taxable year under this provision of the Act is then subject, in turn, to the rules relating to the capitalization of certain construction period interest (sec. 189 of the Code, added in sec. 201 of this Act), the limitations on the deductibility of investment interest (sec. 163(d), as amended by sec. 209 of this Act), and to the limitation on activities not engaged in for profit (sec. 183), in each of the taxable year or years in which interest is treated as paid under this provision.

In adopting the new rule, Congress does not intend to change prior law with regard to defining "interest."

Congress also does not intend to prevent the Treasury or the taxpayer from continuing to be entitled to recharacterize a purported "interest" payment as not true interest in the circumstances.[7] Conversely, the Treasury will have full authority under new section 461(g) to recharacterize as "interest" a payment made by a taxpayer and labeled otherwise than is interest on a loan. Where this reclassifying is appropriate, it may also be appropriate to treat the payment as being a prepayment of interest, thereby making the payment subject to section 461(g).

In certain cases, the Treasury is authorized to treat interest payments under a variable interest rate as consisting partly of interest computed under an average level effective rate of interest and partly of an interest prepayment allocable to later years of the loan.[8]

The Act does not contemplate that interest is to be treated as paid in level payments over the term of every loan. Thus, interest paid as part of a level constant payment (including principal and interest) is not to be subject to this provision merely because the payments consist of a larger interest portion in the earlier years of the loan than in the later years.

Prepaid interest on an indebtedness secured by a "wraparound mortgage" will be subject to the general rule of this provision.[9]

Congress does not intend the new rule to change the treatment of a discount loan by a cash method taxpayer. Nor does the new rule prevent the Treasury from treating interest as paid under the terms of a discount loan rather than as prepaid interest under a conventional loan.

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[6] An accrual method taxpayer can deduct prepaid interest only in the period in which the use of money occurs and only to the extent of the interest cost of using the borrowed funds during that period. It is not material when actual payment occurs, nor is the existence of a fixed liability to make a prepayment of interest sufficient to justify a deduction. Rev. Rul. 68–643, 1968–2 C.B. 76.

[7] It may thus be appropriate in some cases to treat a payment denominated "interest" as, in substance, additional purchase price of property, as a dividend, as payment for an option, etc.

[8] Congress does not intend, however, that a loan calling for interest at a stated rate tied to the "prime rate" necessarily involves prepaid interest, or that variations in the rate of interest as the prime rate (or some other objective measurement) varies necessarily subjects the interest payments to disallowance under this provision.

[9] Since the provision focuses on the fact of prepayment as such, it is immaterial whether the borrower prepays interest (either voluntarily of contractually) to a third-party lender under the first mortgage rather than to the seller of the property. In appropriate cases, however, the Congress does not intend to prevent the Service from recharacterizing part or all of a buyer's (or borrower's) "interest" payment on a wraparound mortgage as, in substance, an additional down payment of principal or as a nondeductible deposit of interest with a third party. See Rev. Rul. 75–99, 1975–1 C.B. 197.

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Points are additional interest charges which are usually paid when a loan is closed and which are generally imposed by the lender in lieu of a higher interest rate. Where points are paid as compensation for the use of borrowed money (and thus qualify as interest for tax purposes) rather than as payment for the lender's services, the points are substituted for a higher stated annual interest rate. As such, points are similar to a prepayment of interest and under the Act are generally to be treated as paid over the term of the loan. This rule also applies to charges similar to points, whether called a loan-processing fee or a premium charge (if such fee or charge is compensation for the use of borrowed money).

The Act permits points paid by a cash method taxpayer on an indebtedness incurred in connection with the purchase or improvement of (and secured by) his principal residence to be treated as paid in the taxable year of actual payment. A loan will not qualify under this exception, however, if the loan proceeds are used for purposes other than purchasing or improving the taxpayer's principal residence, or if loan proceeds secured by property other than his principal residence are used to purchase or improve his residence. The exception applies only to points on a home mortgage, and not to other interest costs on such a mortgage. However, in order to qualify under this exception, the charging of points must reflect an established business practice in the geographical area where the loan is made, and the deduction allowed under this exception may not exceed the number of points generally charged in the area for this type of transaction.

Effective dates

The rules in this provision apply generally to any prepayment of interest (including points) after December 31, 1975. However, a transition rule excepts interest paid before January 1, 1977 (even if the taxpayer's taxable year ends after that date) if there existed on September 16, 1975, and at all times thereafter, either (1) a binding written contract for a prepayment of interest by the taxpayer, or (2) a written loan commitment for a loan to the taxpayer and if the contract or loan commitment required the prepayment of this amount of interest. In either of these situations, however, if the interest is paid on or after January 1, 1977, the payment will be subject to this provision.

Congress intends that no inference should be drawn concerning the deductibility of prepaid interest paid before the effective dates of the new rule. It is expected that deductions for such prepayments will be determined according to the criteria of prior law.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of less than $5 million annually.

b. Limitation on the Deduction for Investment Interest (sec. 209 of the Act and sec. 163(d) of the Code)

Prior law

Section 163 of the Internal Revenue Code provides, in general, that a taxpayer who itemizes his deductions may deduct all interest paid or accrued within the taxable year on his indebtedness. A limitation is imposed under section 163(d) on interest on investment indebtedness. Under prior law the deduction for such interest was limited to $25,000 per year, plus the taxpayer's net investment income and his long-term capital gain, plus one-half of any interest in excess of these amounts. Any remaining amount could be carried over to future years.

Reasons for change

As indicated above, in connection with the discussion of problems which occur with tax shelters, there is a question as to the extent to which a taxpayer should be permitted to shelter or reduce tax on income from the taxpayer's professional or income-producing activities by incurring an unrelated deduction. The Congress felt that the limitation on the deductibility of investment interest should be strengthened, in order to reduce the possibility that this deduction could be used to shelter noninvestment types of income. It was also felt that this provision may have some economic benefits by encouraging taxpayers to focus on the economic viability of particular investments (rather than possible tax advantages resulting from the interest deduction) before borrowing funds in order to make those investments.

Explanation of provisions

Under the Act, interest on investment indebtedness is limited to $10,000 per year, plus the taxpayer's net investment income. No offset of investment interest in permitted against long-term capital gain. An additional deduction of up to $15,000 more per year is permitted for interest paid in connection with indebtedness incurred by the taxpayer to acquire the stock in a corporation, or a partnership interest, where the taxpayer, his spouse, and his children have (or acquired) at least 50 percent of the stock or capital interest in the enterprise. Interest deductions which are disallowed under these rules are subject to an unlimited carryover and may be deducted in future years (subject to the applicable limitation). Under the Act, no limitation is imposed on the deductability of personal interest or on interest on funds borrowed in connection with the taxpayer's trade or business.

As under prior law, investment income (against which investment interest may be deducted) means income from interest, dividends, rents, royalties, short-term capital gains arising from the disposition of investment assets, and any amount of gain treated as ordinary income pursuant to the depreciation recapture provisions (secs. 1245 and 1250 of the Code), but only if the income is not derived from the conduct of a trade or business.

As indicated above, interest on funds borrowed in connection with a trade or business is not affected by the limitation. In this connection, rental property is (as under prior law) generally considered an investment property subject to the limitation, rather than as property used in a trade or business, if the property is rented under a net lease arrangement. The determination of whether property is rented under a net lease arrangement is made separately for each year. For this purpose, a lease is considered to be a net lease for a taxable year either if the taxpayer's trade or business expenses with respect to the property which are deductible solely by reason of section 162 of the code are less than 15 percent of the rental income from the property, or if the taxpayer is guaranteed a specified return, or is guaranteed, in whole or in part, against loss of income.

In determining net investment income, the investment expenses taken into account are real and personal property taxes, bad debts, depreciation, amortizable bond premiums, expenses for the production of income, and depletion, to the extent these expenses are directly connected with the production of investment income. For purposes of this determination, depreciation or depletion with respect to any property is taken into account on a straight-line or cost basis, respectively.

In the case of partnerships, the limitation on the deduction of interest is applied only at the partner level. In other words, each partner separately takes into account his share of the partnership's investment interest and other items of income and expense taken into account for purposes of the limitation. Similar treatment is provided in the case of subchapter S corporations. In this case, each shareholder of the corporation takes into account the investment interest of the corporation and the other items of income and expense which are taken into account for purposes of the limitation on a pro-rata basis in a manner consistent with the way in which the shareholders of the corporation take into account a net operating loss of the corporation.

Generally, these rules are applicable to taxable years beginning after December 31, 1975. However, under a transition rule, prior law (sec. 163(d) before the amendments made under the Act) continues to apply in the case of interest on indebtedness which is attributable to a specific item of property, is for a specified term, and was either incurred before September 11, 1975, or is incurred after that date under a binding written contract or commitment in effect on that date and at all times thereafter (hereinafter referred to as "pre-1976 interest"). As under prior law, interest incurred before December 17, 1969 ("pre-1970 interest") is not subject to a limitation.

Under the Act, carryovers are to retain their character. Thus, carryovers of pre-1976 interest will continue to be deductible under the limitation of prior law. Carryovers of post-1975 interest will be subject to the new rules adopted under the Act.

In a case where the taxpayer has interest which is attributable to more than one period (pre-1970, pre-1976, and post-1975), the taxpayer's net investment income is to be allocated between (or among) these periods. For example, assume a taxpayer has $30,000 of pre-1976 interest and $60,000 of post-1975 interest; also assume that the taxpayer has $45,000 of investment income. Under the Act, one-third of the investment income ($15,000) is to be allocated to the pre-1976 interest, which would be fully deductible (the $25,000 allowance, plus the $15,000 of net investment income—exceeds the $30,000 of pre-1976 interest, which is therefore fully deductible). Two-thirds of the net investment income ($30,000) is allocated to the post-1975 interest; this amount, added to the $10,000 allowance provided under the Act, would result in a total deduction of $40,000 for the post-1975 interest. The remaining amount, ($20,000) could be carried forward.

Effective date

Generally, these rules apply to taxable years beginning after December 31, 1975, subject to certain transition rules discussed above.

Revenue effect

It is estimated that these provisions will result in a revenue gain of $100 million for fiscal year 1977, $110 million for fiscal year 1978, and $145 million for fiscal year 1981.

B. MINIMUM AND MAXIMUM TAX

1. Minimum Tax for Individuals (sec. 301 of the Act and secs. 56–58 of the Code)

Prior law

Under prior law, individuals and corporations paid a minimum tax, in addition to their regular income tax, equal to 10 percent of their items of tax preference, reduced by a $30,000 exemption and their regular tax liability. The tax preferences subject to the minimum tax were: (1) the excluded one-half of capital gains; (2) the excess of percentage depletion over the basis of the property; (3) accelerated depreciation on real property; (4) the bargain element of stock options; (5) accelerated depreciation on personal property subject to a net lease; (6) the excess of amortization of on-the-job training and child care facilities over regular depreciation; (7) the excess of amortization of pollution control facilities over regular depreciation; (8) the excess of amortization of railroad rolling stock over regular depreciation; and (9) excess bad debt reserves of financial institutions. Regular taxes not used to offset preferences in the current year could be carried over for up to 7 additional years.

Reasons for change

The minimum tax was enacted in the Tax Reform Act of 1969 in order to make sure that at least some minimum tax was paid on tax preference items, especially in the case of high-income persons who were not paying their fair share of taxes. However, the previous minimum tax did not adequately accomplish these goals, so the Act contains a substantial revision of the minimum tax for individuals to achieve this objective.

Congress intended these changes to raise the effective tax rate on tax preference items, especially for high-income individuals who are paying little or no regular income tax.

Explanation of provision

The Act raises the minimum tax rate from 10 percent to 15 percent. The Act replaces the $30,000 exemption and deduction for regular taxes allowed under prior law with an exemption equal to the greater of $10,000 or one-half of regular tax liability. In addition, the Act repeals the carryover of regular taxes paid. These changes are intended to raise the effective rate of the minimum tax on tax preferences.

The Act also adds two new items of tax preference to the minimum tax base for individuals and modifies one existing preference item. The new preferences are excess itemized deductions and intangible drilling costs.

The new preference for excess itemized deductions equals the amount by which itemized deductions (other than medical and casualty deductions) exceed 60 percent of adjusted gross income. (Itemized deductions in excess of 100 percent of adjusted gross income are not taken into account in this computation.) This preference is intended to reduce the number of situations in which a person with a large adjusted gross income is able to avoid paying any income tax. Medical and casualty deductions are excluded from this preference item because they are limited to expenses that are beyond the control of the taxpayer.

The new preference for intangible drilling costs applies to those expenses in excess of the amount which could have been deducted had the intangibles been capitalized and either (1) deducted over the life of the well as cost depletion or (2) deducted ratably over 10 years; the taxpayer may choose whichever of these two methods of capitalization is most favorable. The calculation of the amount which could have been deducted under capitalization in a taxable year is to be made for those intangible drilling costs which were paid or incurred in the taxable year. This preference does not apply to taxpayers who elect to capitalize their intangible drilling costs.

The new preference does not apply to nonproductive wells. For this purpose, nonproductive wells are those which are plugged and abandoned without having produced oil and gas in commercial quantities for any substantial period of time. Thus, a well which has been plugged and abandoned may have produced some relatively small amount of oil and still be considered a non-productive well, depending on the amount of oil produced in relation to the costs of drilling.

In some cases it may not be possible to determine whether a well is in fact nonproductive until after the close of the taxable year in question. In these cases, no preference is included in the minimum tax base with respect to any wells which are subsequently determined to be nonproductive. Thus, if a well is proved to be nonproductive after the end of the taxable year but before the tax return for the year in question is filed, that well can be treated as nonproductive on that return. If a well is not determined to be nonproductive by the time the return for the year in question is filed, the intangible expenses with respect to that well are to be subject to the minimum tax. However, the taxpayer may later file an amended return and claim a credit or refund for the amount of any minimum tax paid with respect to that well if the well subsequently proves to be nonproductive.

The preference for accelerated depreciation on personal property is expanded in two ways. Under prior law, it applied only to net leases: the Act expands it to all leases. Also, the definition of accelerated depreciation is expanded to include the acceleration that results from the 20-percent variance under the Asset Depreciation Range (ADR) system. The preference for accelerated depreciation on personal property is not intended to apply to personal property which is leased as an incidental part of a real property lease. For example, the inclusion of a refrigerator in the lease of an unfurnished apartment is not to be treated as a lease of personal property.

There are certain cases in which a person derives no tax benefit from an item of tax preference because, for example, the item is disallowed as a deduction under other provisions of the Code or because the taxpayer has sufficient deductions relating to nonpreference items to eliminate his taxable income.[1] To some extent, the Internal Revenue Service has been able to deal with this issue through regulations. To deal with this problem specifically, the Act instructs the Secretary of the Treasury to prescribe regulations under which items of tax preference (of both individuals and corporations) are to be properly adjusted when the taxpayer does not derive any tax benefit from the preference. For this purpose, a tax benefit includes tax deferral, even if only for one year. Congress, by adding this provision to the Act, does not intend to make any judgment about the authority of the Treasury to issue these regulations under prior law.

The minimum tax is not imposed on tax preferences that make up a net operating loss that is carried forward to a succeeding taxable year. Instead, the minimum tax is imposed on those preferences when the net operating loss reduces taxable income. For preferences from taxable years prior to January 1, 1976, this tax rate will continue at 10 percent even if the net operating loss is deducted in a taxable year beginning after December 31, 1975. For preferences for taxable years beginning after December 31, 1975, the tax rate will be 15 percent. Thus, the year of the preferences, not the year when the net operating loss is deducted, is to determine whether the 10-percent or the 15-percent rate applies.

These changes all apply to individuals, estates, trusts, subchapter S corporations and personal holding companies.

Effective date

These changes are effective for taxable years beginning after December 31, 1975. Carryovers of regular taxes from taxable years beginning before January 1, 1976, will not be allowed in years beginning after December 31, 1975.

Revenue effect

The changes in the minimum tax for individuals will raise $1.0 billion in fiscal year 1977, $1.1 billion in fiscal year 1978 and $1.5 billion in fiscal year 1981.

2. Minimum Tax for Corporations (sec. 301 of the Act and secs. 56–58 of the Code)

Prior law

The minimum tax for corporations was the same as that for individuals except that the capital gains preference equalled 18/48 of net long-term capital gains (rather than one-half of such gains) and the preference for accelerated depreciation on personal property subject to a net lease did not apply.

Reasons for change

Congress believed that, as in the case of individuals, it was appropriate to raise the effective tax rate on corporate tax preferences subject to the minimum tax. However, because corporate income is already subject to two taxes—the corporate income tax and the individual income tax—Congress felt that it was appropriate to retain the deduction for regular taxes in computing the corporate minimum tax.

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[1] For example, preference items giving rise to losses which are suspended under at risk provisions (sec. 465 or sec. 704(d) of the Code) are not to be considered to give rise to a tax benefit until the year in which the suspended deduction is allowed. Similarly, investment interest which is disallowed (under sec. 163(d)) is to be treated as an itemized deduction for purposes of that preference only in the year in which it is allowed (under sec. 163(d)).

Explanation of provision

The Act raises the minimum tax rate for corporations to 15 percent. In place of the $30,000 exemption and deduction for regular taxes under prior law, it substitutes an exemption equal to the greater of $10,000 or regular taxes. It also eliminates the carryover of regular taxes. The "tax benefit" rule applies to corporations as well as to other taxpayers.

Personal holding companies are generally treated as individuals under the minimum tax, and generally where the Act makes a change in the minimum tax that is different for individuals than for corporations, the rule for individuals is used for personal holding companies. Preferences of subchapter S corporations are generally attributed to shareholders under the minimum tax. However, the preference for itemized deductions will, of course, not apply to personal holding companies or to subchapter S corporations since these entities have no adjusted gross income from which to calculate their preference.

The Act provides special rules for timber income of corporations, including both gains from the cutting of timber and long-term gains from the sale of timber. These rules have the effect of exempting timber income from the increase in the minimum tax for corporations. These rules provide that the item of tax preference for timber gains is to be reduced by one-third and then further reduced by $20,000. Also, the deduction for regular taxes is to be reduced by the lesser of (a) one-third or (b) the preference reduction described above. In effect, the adjustments compensate for the general minimum tax rate increases from 10 percent to 15 percent by scaling down the entire minimum tax base, as it relates to timber, by one-third and then subjecting that lower base to a 15-percent rate. This gives the same result as subjecting the normal tax base to a 10-percent rate. The reduction in timber preferences by $20,000 (two-thirds of $30,000), in effect, compensates timber for the loss of the $30,000 exemption.

The Act also retains a regular tax carryover for timber. Taxpayers will first have to determine how much of their corporate income tax is attributable to timber income (including both gains from the cutting of timber and long-term gains from the sale of timber). This allocation is to be made under regulations prescribed by the Secretary of the Treasury. This allocation must be made for years prior to 1976 as well as future years, in order to determine how much of a corporation's existing regular tax carryover remains available for use in 1976 and subsequent years. Congress does not intend that there be a carryover of regular taxes not attributable to timber income. To the extent that regular corporate income taxes attributable to timber exceed the items of tax preference in a taxable year, they may be carried forward for up to 7 additional years. The amount of the carryover that may be deducted in a subsequent year is limited to timber tax preferences in that year, reduced by the timber preference reduction described above, minus the regular tax deduction for the year (as reduced by the regular tax adjustment described above). This has the effect of permitting a carryforward of timber-related regular taxes that are not used in the current year and limiting the use of that carryforward to the part of the minimum tax base that is attributable to timber-related capital gains income.

Effective date

Generally, the minimum tax changes are effective for taxable years beginning after December 31, 1975. However, for taxable years beginning in 1976, corporations are to compute their minimum tax under both prior law and the new law and pay the average of the two minimum taxes. Also, regular tax carryovers from prior years can be deducted in taxable years beginning before July 1, 1976 (as changed by later legislation).[1]

For financial institutions who are eligible for excess bad debt reserve deductions, the effective date is delayed until December 31, 1977.

Revenue effect

The increases in the minimum tax for corporations will increase budget receipts by $59 million in fiscal year 1977, $124 million in fiscal year 1978 and $204 million in fiscal year 1981.

3. Maximum Tax Rate (sec. 302 of the Act and sec. 1348 of the Code)

Prior law

Under prior law, the maximum marginal tax rate on taxable income from personal services was 50 percent. For this purpose, income from personal services (in the past this was referred to as "earned income") included wages, salaries, professional fees or compensation for personal services (including royalty payments to authors or inventors) and, for an individual engaged in a trade or business where both personal services and capital are material income-producing factors, a reasonable amount (not to exceed 30 percent) of his share of the net profits from the business. Personal service income for this purpose did not include deferred compensation, penalty distributions from owner-employee plans, lump-sum distributions from pension plans or distributions from employee annuity plans.

The amount of personal service income eligible for the 50-percent maximum tax was reduced in three ways. First, it was reduced by trade or business deductions allowable under section 62 (which excludes most trade or business deductions of employees) properly allocable to personal service income. Second, it was reduced by a pro rata share of deductions from adjusted gross income used in computing taxable income (including all itemized deductions, the standard deduction and the deduction for personal exemptions). Third, it was reduced by the taxpayer's items of tax preference (as defined under the minimum tax) or the average of the taxpayer's tax preferences over the current year and the four preceding years, whichever is greater, in excess of $30,000.

For married couples, the maximum tax only applies if they file a joint return, and taxpayers cannot use the maximum tax provision if they use income averaging.

Reasons for change

Congress believed that one way to reduce the incentive for making use of tax preferences was to continue the lower top bracket rate (i.e.,

[1] The Tax Reform Act of 1976 included an effective date of January 1, 1976, for the repeal of the carryover, but H.R. 1144 (P.L. 94-568) amended this to July 1, 1976.

50 percent) on personal service income but to reduce the amount of personal service income eligible for this benefit to the extent that the taxpayer uses tax preferences. This "preference offset" in prior law, however, was considerably weakened by the $30,000 exemption.

Also, Congress thought it was appropriate to extend the benefits of the 50-percent maximum tax rate to deferred compensation. Under prior law, there were cases where an individual could retire on a pension; and, even though his before-tax income would fall, his after-tax income would rise because he would lose the benefit of the maximum tax.

Explanation of provision

The Act eliminates the $30,000 exemption to the preference offset and the five-year averaging provision. These changes will make the maximum tax a more effective deterrent to use of tax preferences and also will considerably simplify it.

Also, the Act extends the benefits of the maximum tax to deferred compensation including pensions and annuities. This extension applies to pensions and annuities that are personal services income. For example, it excludes those pensions and annuities in which an individual buys the pension or annuity for himself where there is no connection with earning income with personal services. Income deferred under individual retirement accounts will also qualify for the maximum tax. Lump-sum distributions which are taxed under special rules and certain distributions from H.R. 10 pension plans or Individual Retirement Accounts (IRA's) do not qualify for the maximum tax.

Effective date

The changes in the maximum tax are effective for taxable years beginning after December 31, 1976.

Revenue effect

The changes in the maximum tax will increase revenues by $4 million in fiscal year 1977, $24 million in fiscal year 1978 and $43 million in fiscal year 1981.

C. EXTENSION OF INDIVIDUAL INCOME TAX REDUCTIONS

(Secs. 401–402 of the Act and Secs. 42, 43, and 141 of the Code)

Prior law

The Tax Reduction Act of 1975 (Public Law 94–12) enacted three individual income tax cuts for the first six months of 1975. These were an increase in the standard deduction, a general tax credit and an earned income credit. The Revenue Adjustment Act of 1975 (Public Law 94–164) enacted somewhat larger tax cuts for the first six months of 1976.

Prior to the 1975 tax reduction, the minimum standard deduction (or low-income allowance) was $1,300. The Tax Reduction Act increased it to $1,600 for single returns and to $1,900 for joint returns for the year 1975. The tax reduction in the Revenue Adjustment Act of 1975, on a full-year basis, would have increased the minimum standard deduction to $1,700 for single returns and to $2,100 for joint returns.

The percentage standard deduction was 15 percent prior to 1975. The Tax Reduction Act of 1975 and the Revenue Adjustment Act increased it to 16 percent for 1975 and the first half of 1976, respectively.

The maximum standard deduction was $2,000 before 1975. The Tax Reduction Act of 1975 increased it to $2,300 for single returns and to $2,600 for joint returns for 1975. On a full-year basis, the Revenue Adjustment Act of 1975 would have increased it to $2,400 for single returns and to $2,800 for joint returns for 1976.

The Tax Reduction Act of 1975 also provided a nonrefundable credit of $30 for each taxpayer and dependent for 1975. The Revenue Adjustment Act of 1975, on a full-year basis, would have increased this credit to the greater of $35 per capita or 2 percent of the first $9,000 of taxable income.

In addition, the Tax Reduction Act of 1975 included a refundable tax credit equal to 10 percent of the first $4,000 of earned income, phased out as adjusted gross income rises from $4,000 to $8,000. This earned income credit applied only to families who maintained a household for at least one dependent child for whom they were entitled to claim a personal exemption. The earned income credit was extended for the first six months of 1976 in the Revenue Adjustment Act of 1975. Also, the credit for 1975 was modified to provide that it be disregarded in determining eligibility for, or benefits under, Federal or federally-assisted aid programs, as long as the individual was a recipient of benefits under the program in the month before receiving a tax refund resulting from the earned income credit.

The Tax Reduction Act of 1975 provided that the changes in the standard deduction and the general tax credit be reflected in lower withheld and estimated taxes for the last eight months of 1975. The Revenue Adjustment Act of 1975 extended those same withholding rates and estimated tax requirements through June 30, 1976. Subsequent legislation extended the withholding rates through September 30, 1976.

The Revenue Adjustment Act of 1975 reduced taxes only for the first half of 1976. This was achieved by enacting a reduction in tax liability approximately equal to one-half of the full-year reduction described above and by providing that this tax cut be entirely reflected in lower withheld and estimated tax payments in the first six months of 1976.[1]

Reasons for change

Without new legislation, income tax withholding rates would have risen by $13 billion on October 1, 1976. Congress believed that economic conditions did not warrant this tax increase. While the recovery from the 1974–75 recession has proceeded far enough that we have now exceeded the level of output that existed prior to the recession, which began at the end of 1973, there is still a large gap between what the economy is capable of producing and what it actually produces. The unemployment rate was 7.8 percent in September 1976, as compared to its prerecession level of less than 5 percent, while capacity utilization in manufacturing was only 73 percent, as compared to 83 percent in 1973.

An extension of the expiring 1975 income tax cuts at least through 1977 is needed to permit a continuation of the economic recovery. This extension does not provide any new fiscal stimulus to the economy; it only prevents the withdrawal of existing stimulus. In 1977, Congress plans to review the economic situation to see if a further income tax cut extension is appropriate.

The extension of the tax cuts also serves purposes other than economic stimulus. The increase in the standard deduction represents a major simplification of the tax law because it will encourage taxpayers who file over 9 million tax returns to switch from itemizing their deduction to using the standard deduction. Also, the increase in the standard deduction creates greater equity between users of the standard deduction and itemizers, since itemized deductions have risen in recent years as a result of inflation while there has been no comparable increase in the standard deduction. For these reasons, Congress believed the increases in the standard deduction should be made permanent.

The income tax cuts also raised the income level at which people begin to pay income taxes (the tax threshold) above the current poverty level. If taxes were allowed to rise after September 30, the income

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[1] For the minimum standard deduction, the half-year tax cut for 1976 involved an increase from $1,300 to $1,500 for single returns and to $1,700 for joint returns (compared with increases to $1,700 and $2,100 respectively in the full-year version of the tax cuts). The maximum standard deduction was increased in the half-year version from $2,000 to $2,200 for single returns and to $2,400 for joint returns (compared with increases to $2,400 and $2,800 respectively in the full-year version). The percentage standard deduction was increased from 15 percent to 16 percent in the half-year version, which is the same level as in the full-year version.

For the general tax credit, the half-year variant was a credit equal to the greater of $17.50 per capita or one percent of the initial $9,000 of taxable income (compared with a credit equal to the greater of $35 per capita or 2 percent of the first $9,000 of taxable income in the full-year version).

For the earned income credit, the half-year version was 5 percent of the initial $4,000 of earnings (compared with a 10-percent rate in the full-year version) with the same income phaseout as mentioned above.

tax threshold would have fallen substantially below the poverty level. This is shown in Table 1, which compares the poverty level in 1976 with the income tax threshold with and without the tax cuts. If the tax cuts had expired, the poverty level would be $1,550 above the threshold for a family of four; thus, such a family could be liable for a Federal income tax burden as high as $222.

TABLE 1.—POVERTY LEVELS AND FEDERAL INCOME TAX THRESHOLDS, 1976

	1976 poverty level	Income tax threshold: Without tax cuts [1]	Income tax threshold: With tax cuts [2]
Family size:			
1	$2,970	$2,050	$2,700
2	3,840	2,800	4,100
3	4,570	3,550	5,100
4	5,850	4,300	6,100
5	6,900	5,050	7,083
6	7,770	5,800	8,067

[1] Personal exemption of $750 and minimum standard deduction of $1,300.
[2] Personal exemption of $750, minimum standard deduction of $1,700 for single returns and $2,100 for joint returns, and $35 tax credit for each taxpayer and dependent.

Congress also decided to extend the earned income credit. This provides needed tax relief to a hard-pressed group in the population—the lower income worker. It also provides a work incentive, since the credit is based on the amount of earned income. In effect, it offsets the social security payroll taxes payable with respect to those who are working but whose incomes are slightly, if any, above the levels of those on welfare. This is designed to improve the financial position of those who work relative to those remaining on welfare.

Explanation of provisions

(a) *Standard deduction.*—The Act makes permanent the increases in the standard deduction from the Revenue Adjustment Act of 1975, thus, making the increases effective for 1976 and subsequent years. It increases the minimum standard deduction (or low-income allowance) to $1,700 for single returns and $2,100 for joint returns; increases the percentage standard deduction to 16 percent; and increases the maximum standard deduction to $2,400 for single returns and $2,800 for joint returns. It also modifies the income tax filing requirements to reflect the increases in the minimum standard deduction.

(b) *General tax credit.*—The Act continues the general tax credit from the Revenue Adjustment Act of 1975 through the last 6 months of 1976 and for all of 1977. This credit is the greater of $35 per taxpayer and dependent or 2 percent of the initial $9,000 of taxable income.

(c) *Earned income credit.*—The Act extends the earned income credit through 1977, and also extends the provision that the credit be disregarded in determining eligibility for benefits under Federal or federally-assisted aid programs. Also, the eligibility for the credit is broadened in two ways. The Act makes the credit available to a parent who maintains a household for a child who is either under 19 or a student even though the parent is not entitled to a personal exemption for the child. Also, it extends the credit to a parent who maintains a household for an adult disabled dependent for whom he is entitled to claim a personal exemption.

(d) *Withholding rates.*—The Act extends the income tax withholding rates that have been in use since May 1975 through the end of 1977. After that, it instructs the Secretary of the Treasury to issue new withholding tables that are to be the same as those which were in effect prior to May 1975, except that they are to be adjusted to reflect the permanent increases in the standard deduction made by the Act.

Effective dates

The changes in the standard deduction are effective for taxable years beginning after December 31, 1975. The general tax credit and changes in the earned income credit are effective for taxable years beginning after December 31, 1975, and before January 1, 1978. The "disregard" applies to refunds received after December 31, 1975. The extension of the withholding rates is effective for wages paid after September 14, 1976.

Revenue effect

These tax reductions will reduce receipts by $14.4 billion in fiscal year 1977, $9.3 billion in fiscal year 1978, and $5.0 billion in fiscal year 1981.

D. TAX SIMPLIFICATION IN THE INDIVIDUAL INCOME TAX

1. Revision of Tax Tables for Individuals (sec. 501 of the Act and secs. 3, 4, 36, 144, 1211, 1304 and 6014 of the Code)

Prior law

Under prior law, a taxpayer whose adjusted gross income was under $10,000 ($15,000 for 1975 only) and who claimed the standard deduction was required to use the optional tax tables. These tables had AGI brackets as horizontal row designations; marital status and number of exemptions as vertical column headings; and the amount of tax in the resulting cell. A taxpayer whose income was greater than $10,000 ($15,000 for 1975 only) or who itemized his deductions was required to compute his tax using the tax rates.

Reasons for change

The optional tax table set-up which provided a different table for each number of exemptions claimed by the taxpayer just to cover up to $10,000 of AGI resulted in 6 pages of fine print, representing 12 optional tax tables in the instructions accompanying the income tax return. The 1975 tables extending up to $15,000 of AGI covered 10 pages in the instructions. In addition, a separate publication was required for taxpayers claiming 13 or more exemptions. This system was a considerable source of taxpayer error since taxpayers were not always sure which table to use or, because of the necessarily small size of the print, which was the proper tax figure to enter on their returns. In the interest of taxpayer compliance and simplification of the instructions as well as increased accuracy in the determination of the proper tax by taxpayers, the Congress believed it desirable to eliminate the existing optional tax table system and to adopt a table based on taxable income. This should make it possible to print the tax table on three pages.

Explanation of provision

The Act revises the existing optional tax tables by providing that taxpayers with taxable incomes of $20,000 or less are to use a tax table based on taxable income which is to be prescribed by the Secretary of the Treasury on the basis of the existing tax rates. This table is to be used by individuals, estates, and trusts.

In constructing such a taxable income table, the Secretary has the authority to design a bracket system analogous to that in the prior optional tax table (including a zero-tax bracket for rounding purposes). In order to limit the taxable income bracket table to three pages and to have the tax table run to $20,000 of taxable income, the tax liability of an individual may have to be several dollars higher at the bottom of one bracket than at the top of the next lower bracket. (This was the case with the optional tax table under prior law.) However, the amount involved is only a small portion of the existing tax. This change is necessary to achieve the simplification and taxpayer accuracy that is generally believed to be desirable.

In order to use the tax table, the taxpayer must subtract from his adjusted gross income the amount of his personal exemptions and itemized deductions or standard deduction (either percentage or minimum standard deduction). The amount of tax determined from the table is tax before credits and is to be reduced by any tax credits (such as the $35 per capita or 2 percent of taxable income credit provided by the Act as well as other credits). This will entail additional computations for some taxpayers but should, on balance, result in improved taxpayer compliance and greater accuracy than was achieved under the prior system. (It is estimated that over 90 percent of taxpayers will use the new tables.)

The computation of the 16-percent standard deduction is not expected to cause significant difficulty because it applies at an income level where (prior to 1975) taxpayers would not have been able to use the optional tax table. They would have had to use the tax rates for a computation which involves the same type of multiplication as the standard deduction computation.

In the case of a taxpayer with a short taxable year, the taxpayer still annualizes as he did under section 443(b).

Effective date

This provision applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision will not have any revenue effect.

2. Alimony Payments (sec. 502 of the Act and secs. 62 and 3402(m)(2) of the Code)

Prior law

Under prior law, a deduction for alimony could be taken as an itemized deduction from adjusted gross income in the year paid in arriving at taxable income. The recipient of alimony was required to include such payments in his or her income and to pay tax on them. Payments for the support of a spouse which were not required by a divorce or separation agreement and payments for the support of children were considered normal living expenditures on the part of a taxpayer. Such expenditures were not deductible and were not included in the income of the recipients.

Reasons for change

The Congress believes that the splitting of income or assignment of income through the payment of alimony was not properly treated under prior law which permitted only an itemized deduction for alimony. Instead, the Congress believes it is more appropriate to take the payment of alimony into account as a deduction in arriving at adjusted gross income, rather than as one of the itemized deductions which are generally limited to personal expenses. As a deduction from gross income, the alimony deduction would be available to taxpayers who elect the standard deduction as well as to those taxpayers who elect to itemize their deductions.

Explanation of provision

The Act takes the payment of alimony into account in determining adjusted gross income.

The Act moves the deduction of alimony payments from an itemized deduction to a deduction from gross income to arrive at adjusted gross income (sec. 62). The Act also makes a conforming change in the section providing a withholding allowance for itemized deductions (sec. 3402(m)(2)). This change includes the deduction for alimony as one of the deductions taken into account for determining withholding allowances in order to avoid overwithholding. Previously such allowances, which were based on estimated itemized deductions, could not take alimony into account.

Effective date

This provision is to apply to taxable years beginning after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $7 million in fiscal year 1977, $44 million in fiscal year 1978, and $59 million in fiscal year 1981.

3. Retirement Income Credit (sec. 503 of the Act and sec. 37 of the Code)

Prior law

Under prior law, individuals who were 65 years of age or over could receive a tax credit based on the first $1,524 of retirement income. The credit was 15 percent of this retirement income. Each spouse who was 65 or over could compute his tax credit on up to $1,524 of his own retirement income (whether the couple filed separate or joint returns). Alternatively, spouses 65 or over who filed joint returns could compute their credit on up to $2,286 of retirement income (one and one-half times $1,524) even though one spouse received the entire amount of the retirement income.

To be eligible for the credit an individual had to receive more than $600 of earned income in each of 10 prior years. (A widow or widower whose spouse had received such earned income was considered to have met this earned income test).

Retirement income, for purposes of this credit, included taxable pensions and annuities, interest, rents, dividends, and interest on Government bonds issued especially for the self-employed setting aside amounts under "H.R. 10" retirement-type plans.

The maximum amount of retirement income which an individual could claim ($1,524, or $2,286 for certain married couples) had to be reduced by two broad categories of receipts. First, it was reduced on a dollar-for-dollar basis by the amount of social security, railroad retirement, or other exempt pension income received by the taxpayer.

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Second, the maximum amount of retirement income eligible for the credit was further reduced by one-half of the annual amount of earned income over $1,200 and under $1,700 and by the entire amount of earned income in excess of $1,700. This reduction for earned income did not apply to individuals who had reached age 72.

Individuals under age 65 also were eligible for tax credits for retirement income but only with respect to pensions received under a public retirement system. Only income from a pension, annuity, retirement, or similar fund or system established by the United States, a State, or a local government, qualified under this provision. This restriction of retirement income for purposes of the credit to income from a public retirement system applied only until the individual reached the age of 65; thereafter, he was entitled to take the credit on the same basis as other individuals who had reached that age.

Reasons for change

The Congress concluded that there was a need to redesign the retirement income credit for several basic reasons. One reason was that the credit needed updating. Most of the features of the credit had not been revised since 1962 when the maximum level of income on which the credit was computed was set and when the earnings limits were established.[1] Since then, there have been numerous revisions of the social security law which substantially liberalized the social security benefits. As a result, the maximum amount of income eligible for the credit was considerably below the average annual social security primary benefit received by a retired worker and the average social security primary and supplementary benefit that could be received by a retired worker and spouse (one and one-half times the primary benefit).

In addition, the complexity of the retirement income credit prevented it from providing the full measure of relief it was intended to grant to elderly people. This complexity stemmed from an attempt to pattern the credit after the social security law. For example, to claim the credit on his tax return, a taxpayer had to show that he met the test of earning $600 a year for 10 years; he also had to segregate his retirement income from his other income; he had to reduce the maximum amount of retirement income eligible for the credit by the amount of his social security income and by specified portions of his earned income under the work test; a credit of one and one-half times the basic credit was available for a man and his wife; and a credit was available for each spouse separately if each spouse independently met the eligibility tests.

The purpose of all these provisions was to treat taxpayers who received little or no social security benefits on as equal a basis as possible to that provided for recipients of tax-exempt social security benefits. However, the result was to impose severe compliance burdens on large numbers of elderly people, many of whom are not skillful in filing tax returns. Such individuals had to compute their retirement income credit on a separate schedule, which occupied a full page in the tax return packet, with 19 separate items, some of which involved computa-

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[1] One other feature of the credit was adopted in the 1964 Revenue Act. This provision allowed spouses 65 and over who file joint returns to claim a credit on up to $2,286 of retirement income (one and one-half times the $1,524 maximum base for single people) even if one spouse received the entire amount of the married couple's retirement income.

tions in three separate columns (see the form shown below). It is these complexities which undoubtedly accounted for the fact that some of the organizations representing retired people estimated that as many as one-half of all elderly individuals eligible to use the retirement income credit did not claim this credit on their tax returns.

Schedules E&R (Form 1040) 1975 **Schedule R—Retirement Income Credit Computation** Page 2

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side) | Your social security number

If you received earned income in excess of $600 in each of any 10 calendar years before 1975, you may be entitled to a retirement income credit. If you elect to have the Service compute your tax (see Form 1040 instructions, page 5), answer the question for columns A and B below and fill in lines 2 and 5. The Service will figure your retirement income credit and allow it in computing your tax. Be sure to attach Schedule R and write "RIC" on Form 1040, line 17. If you compute your own tax, fill out all applicable lines of this schedule.
Married residents of Community Property States see Schedule R Instructions.

Joint return filers use column A for wife and column B for husband. All other filers use column B only. Did you receive earned income in excess of $600 in each of any 10 calendar years before 1975? (Widows or widowers see Schedule R Instructions.) If "Yes" in either column, furnish all information below in that column. Also furnish the combined information called for in column C for both husband and wife if joint return, both 65 or over, even if only one answered "Yes" in column A or B.	A ☐ Yes ☐ No	B ☐ Yes ☐ No	C Alternative Computation (Combined information of husband and wife if joint return and both 65 or over)
1 Maximum amount of retirement income for credit computation	$1,524 00	$1,524 00	$2,286 00
2 Deduct: (a) Amounts received as pensions or annuities under the Social Security Act, the Railroad Retirement Acts (but not supplemental annuities), and certain other exclusions from gross income			
(b) Earned income received (does not apply to persons 72 or over): (1) If you are under 62, enter the amount in excess of $900			R
(2) If you are 62 or over but under 72, enter amount determined as follows: If $1,200 or less, enter zero; if over $1,200 but not over $1,700, enter ½ of amount over $1,200; or if over $1,700, enter excess over $1,450			
3 Total of lines 2(a) and 2(b)			
4 Balance (subtract line 3 from line 1). If column A, B, or C is more than zero, complete this schedule. If all of these columns are zero or less, do not file this schedule.			
5 Retirement income: (a) If you are under 65: Enter only income received from pensions and annuities under public retirement systems (e.g. Fed., State Govts., etc.) included on Form 1040, line 15			
(b) If you are 65 or older: Enter total of pensions and annuities, interest, dividends, proceeds of retirement bonds, and amounts received from individual retirement accounts and individual retirement annuities that are included on Form 1040, line 15, and gross rents from Schedule E, Part II, column (b). Also include your share of gross rents from partnerships and your proportionate share of taxable rents from estates and trusts			
6 Line 4 or line 5, whichever is smaller			
7 (a) Total (add amounts on line 6, columns A and B)			
(b) Amount from line 6, column C, if applicable			
8 Tentative credit. Enter 15% of line 7(a) or 15% of line 7(b), whichever is greater			
9 Amount of tax shown on Form 1040, line 16c			
10 Retirement income credit. Enter here and on Form 1040, line 48, the amount on line 8 or line 9, whichever is smaller. Note: If you claim credit for foreign taxes or tax free covenant bonds, skip line 10 and complete lines 11, 12, and 13, below			
11 Credit for foreign taxes or tax free covenant bonds			
12 Subtract line 11 from line 9 (if less than zero, enter zero)			
13 Retirement income credit. Enter here and on Form 1040, line 48, the amount on line 8 or line 12, whichever is smaller			

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Moreover, the retirement income credit discriminated among individuals depending on the source of their income. As indicated above, the credit was available only to those with retirement income—that is, some form of investment or pension income. Elderly individuals who had to support themselves by earning modest amounts and who had no investment or pension income were not eligible for any relief under the prior credit. This gave rise to considerable criticism as to the fairness of the tax law: many elderly individuals who relied entirely on earned income maintained that they should have been allowed the same retirement income credit as those who lived on investment income. Under the prior credit, elderly people who relied entirely on earned income were required to pay substantially higher taxes than the taxes paid by individuals who were comparable in every respect except that they had significantly larger incomes which came from investments. Another criticism was that higher taxes on earnings than on retirement income served as a disincentive to work.

Explanation of provision

To deal with the problems above, the Congress first updated the amount on which the credit is based. Then it simplified the credit to the extent practicable by eliminating complicating, substantive features of the credit which previously were included in order to parallel social security treatment. Thus the $600 for ten-years earnings test is eliminated, as is the requirement that the taxpayer have "retirement income" (that is, pension or investment income) in order to be eligible for the credit. In addition, the variation in treatment of married couples depending on whether they are separately eligible for the credit is eliminated.

The Congress has increased the equity of the provision by making the credit more generally available to those age 65 or over. The major change in this area is the elimination of the cutback of the credit for earned income. The Congress concluded, however, that in view of the broadening of the credit generally and the change in its nature to focus relief on low- and middle-income taxpayers, it is not necessary to provide the credit to higher income taxpayers. Consequently, the maximum amounts of the base for the credit are reduced by one-half of the adjusted gross income in excess of $7,500 for a single person and $10,000 for a married couple filing a joint return ($5,000 for a married taxpayer filing a separate return). Thus, for a single person, the credit would no longer be available when his adjusted gross income reaches $12,500 ($7,500 plus two times $2,500). For a joint return the credit would be available up to an income level of $15,000 if only one spouse is age 65 or over and up to $17,500 if both spouses are age 65 or over.

The most significant extension of the credit provided by this Act is that it will for the first time benefit low-income earners age 65 or over regardless of whether they receive retirement income or earned income. Since the credit is no longer limited to retirement income, it has been renamed the "credit for the elderly."

Taxpayers age 65 and over.—More specifically, the credit for the elderly provided by the Act liberalizes the retirement income credit available under prior law for those age 65 and over in four respects. First, the amount of income with respect to which the 15-percent credit may be claimed is increased to $2,500 for a single person and for a married couple filing jointly if only one spouse is 65 or over, and to $3,750 in the case of a married couple filing a joint return where both are 65 or over.

Second, all types of income, including earned income, are to be eligible for the credit. Third, the maximum amounts on which the credit is based are reduced by one-half of adjusted gross income in excess of $7,500 for a single person and $10,000 for a married couple filing a joint return ($5,000 for a married individual filing a separate return). Because of the cutback based on the couple's combined income, the credit is available to married couples only if they file a joint return, except in the case of a husband and wife who live apart at all times during the taxable year, which is treated as a "nonlegal" separation and is evidence that filing a joint return might not be possible. Fourth, the credit is to be available regardless of whether the individual has had work experience (i.e., has received earned income) in prior years.

Under the Act, the amount with respect to which the 15-percent credit may be claimed (referred to in the Act as the "section 37 amount") may not exceed a maximum amount (referred to in the Act as the "initial amount") of $2,500 in the case of a single individual age 65 or over or a married couple filing a joint return where only one spouse is age 65 or over. In the case of a married couple filing a joint return where both spouses are age 65 or over, the maximum amount is $3,750 and if a married individual age 65 or over files a separate return the maximum amount is $1,875. (As under prior law, the age of an individual is to be determined as of the close of the taxable year in question.) This credit is available whether or not the individual (or his spouse in the case of a joint return) has received $600 of earned income in ten prior years.

One feature of the prior law parallel to social security recipients is retained, however. As under prior law, the maximum base for the credit is reduced by amounts received by the individual (and by his spouse in the case of a married couple filing a joint return) as a pension or annuity under the Social Security Act, the Railroad Retirement Acts, or as a pension or annuity which is otherwise excluded from gross income.

In conjunction with the minimum standard deduction of $1,700 for single persons and $2,100 for joint returns and the $35 per capita or two percent of taxable income up to $9,000 tax credit, the credit for the elderly will permit a single elderly person to receive approximately $5,800 of earned income or pension income before becoming taxable. For a joint return with one spouse age 65 or over, the tax-free level is about $7,300. With both spouses age 65 or over, the tax-free income level is about $9,200.

The change in the retirement income credit to a tax credit for the elderly and the increase in the base for the credit will increase the number of returns with at least one taxpayer age 65 or over benefiting from about 400 thousand to about 2.4 million.

An example of the type of simplified tax credit form for taxpayers age 65 and over which these changes make possible is shown below. This form is less than one-third as long as the prior form and involves only one column instead of three. It requires the taxpayer to select the appropriate amount on which to compute the credit and to deduct from this amount his social security or certain other tax-exempt income. It also requires the taxpayer to reduce the base for the credit by one-half the adjusted gross income above specified levels. On the balance, the credit is computed at a 15 percent rate, and this is then entered on the basic form 1040 as a tax credit.

SCHEDULE R.—*Credit for taxpayers age 65 or over*

MAXIMUM AMOUNTS FOR CREDIT COMPUTATION

If you are: (check one box):	*Then your maximum amount for credit computation is—*
☐ Single	$2,500
☐ Married filing jointly and only one spouse is 65 or over	2,500
☐ Married filing jointly, both age 65 or over	3,750
☐ Married filing a separate return and age 65 or over	1,875

1. Enter (from above) your maximum amount for credit computation	
2. Amounts received as pensions or annuities under the Social Security Act, the Railroad Retirement Acts (but not supplemental annuities) and certain other exclusions from gross income	
3. Adjusted gross income reduction. Enter *one-half* of adjusted gross income (line 15 form 1040) in excess of $7,500 if single; $10,000 if married filing jointly; or $5,000 married filing separately	
4. Total of lines 2 and 3	
5. Balance (subtract line 4 from line 1); if more than zero complete this form; if zero or less, do not file this form	
6. Amount of credit; enter (here and on form 1040, line 48) 15 percent of line 5 but not more than the total income tax on form 1040, line 18	

Public retirees under age 65.—The Act makes three changes in the retirement income credit for taxpayers who are public retirees under age 65; otherwise, the credit for public retirees age 65 is left generally the same as prior law. First, the maximum base for the credit is increased (as in the case of taxpayers over age 65) to $2,500 for a single taxpayer, $3,750 for a married couple filing a joint return, and $1,875 for a married individual filing a separate return. Because of the retention of the earnings cutback of prior law, the Congress did not believe it necessary to apply the adjusted gross income phaseout in order to limit the benefits of the credit to the low- and middle-income taxpayer generally. Second, the $600 a year of earnings for 10 years test is also eliminated for taxpayers under age 65. Third, in the case of joint returns where one spouse is age 65 or over and therefore eligible for the elderly credit and the other spouse is under age 65 with public retirement income, the couple must elect for the taxable year whether to use the prior law retirement income credit or the new elderly credit. This election procedure was adopted principally to avoid the serious complexity that would result from a combination of the retirement income credit for public retirees and the new elderly credit (especially the application of the adjusted gross income phaseout).

Under this procedure, if the prior law public retirement provision is elected, the provisions restricting the base of the retirement income to retirement income as defined under prior law for taxpayers over age 65 apply. The computation of the credit in these situations where a couple elects to have essentially the prior law procedure apply is modified by permitting the spouses to allocate the maximum base of the credit, $3,750, between them in any way they wish so long as no more than $2,500 is allocated to one spouse. After the allocation, the regular reductions provided by prior law are to apply and any remaining credit base of either spouse is to be aggregated as the base for the final credit computation in essentially the same manner as the dual computation under prior law.

Miscellaneous provisions.—As under prior law, the Act provides that the credit for the elderly may not exceed the individual's (or the married couple's, in the case of a joint return) tax for the year. For this purpose, however, the Act provides that the credit for the elderly is to be taken before the foreign tax credit. In other words, the tax for the year is to be computed before reduction for the foreign tax credit. A correlative change is made by the Act in the limitation on the foreign tax credit to reflect this reordering of the priority of these two credits. Thus, the limitation on the foreign tax credit is to be computed with respect to the tax for the year after reduction for the retirement income credit.

In addition, although the credit is not available to nonresident aliens generally, it is available to nonresident aliens who are married to citizens or residents of the United States who agree to be taxed on their worldwide income and to make records of their combined income available for inspection to the IRS (i.e., those nonresident aliens treated as residents by section 1012 of the Act).

Effective date

This provision is to apply to taxable years beginning after December 31, 1975.

Revenue effect

This provision will reduce receipts by $391 million in fiscal year 1977, $340 million in fiscal year 1978, and $340 million in fiscal year 1981.

4. Credit for Child Care Expenses (sec. 504 of the Act and secs. 44A, 214 and 3402(m)(2) of the Code)

Prior law

Under prior law, taxpayers were permitted an itemized deduction for expenses for the care of a dependent child, incapacitated dependent or spouse, or for household services when the taxpayer maintained a household for any of these qualifying individuals. An eligible dependent child had to be under age 15 and the taxpayer had to be able to claim a personal exemption for the child. These expenses had to be related to employment; that is, they had to be incurred to enable the taxpayer to be gainfully employed.

Eligible expenditures were limited to a maximum of $400 a month. Services provided for children outside the taxpayer's home were further limited to $200 a month for one dependent, $300 for two, and $400 for three or more. (No deduction was allowed for the care of an incapacitated dependent over age 14 or spouse outside the taxpayer's home.) The amount of the eligible expenses which could be deducted was also reduced by one-half of adjusted gross income in excess of

$35,000 a year. No deduction was allowed, however, for payments to relatives.

To claim this deduction, a husband and wife were generally required to file a joint return. Both had to be employed substantially full time, that is, three-quarters or more of the normal or customary workweek or the equivalent on the average. However, a spouse who had been deserted for an entire year could file as a single person.

In the case of a disabled dependent, the deductible expenses were reduced by the dependent's adjusted gross income plus disability income in excess of $750.

Reasons for change

The Congress believed that the availability of the child and dependent care deduction under prior law was unduly restricted by its classification as an itemized deduction and by its complexity.

Treating child care expenses as itemized deductions denied any beneficial tax recognition of such expenses to taxpayers who elected the standard deduction. The Congress believed that such expenses should be viewed more as a cost of earning income than as personal expenses. One method for extending the allowance of child care expenses to taxpayers generally and not just to itemizers was to replace the itemized deduction with a credit against income tax liability for a percentage of qualified expenses. While deductions favor taxpayers in the higher marginal tax brackets, a tax credit provides relatively more benefit to taxpayers in the lower brackets.

Because there was a $400 a month limit on the deduction under prior law, a complex child care deduction form was necessary. The child care allowance could be made simpler and the form simplified if it were computed on an annual instead of a monthly basis. The Congress also believed that additional unnecessary complications resulted from the distinction between expenses for care of children incurred inside and outside the home and from the requirement that the allowable deduction be reduced by the dependent's disability income. Allowing the same amount for the expenses of caring for children whether inside or outside the home and replacing the $200, $300 and $400 monthly maximum deductions for such outside expenses for the care of one, two, or three children, with annual ceilings based on one and two or more dependents, would further reduce the complexity of the provision.

The rule allowing the deduction in the case of joint returns only where both spouses work full time seemed unduly restrictive. The full-time earnings test was intended to prevent one spouse from working part time, perhaps in a nominal capacity, in order to obtain the benefits of a deduction which could amount to $4,800 a year. The Congress believed this type of abuse could be prevented by an alternative rule limiting the allowable expenses to the earnings of the spouse with the smaller earnings. Such a limitation would enable a married or single taxpayer with a qualifying dependent to treat child care expenses as a cost of earning income.

The Congress also believed that child care expenses should be allowed when one spouse works and the other is a full-time student. The spouse attending school cannot reasonably be expected to provide child care to enable the other spouse to work. In these circumstances, the expenses incurred to pay for child care are, in fact, necessary for the taxpayer to be gainfully employed.

The Congress believed that the one-year waiting period before a deserted spouse could claim child care expenses was too long and adopted a shorter qualifying period to mitigate hardships.

Limiting the deduction of child care expenses to parents who claim a child as a dependent denied the deduction to a divorced or separated parent with custody of a child, who did not supply more than half of the child's support and could not claim the child as a dependent, but who nevertheless incurred child care expenses in order to work. The Congress believed that the parent who has custody of the child for the greater period of the year should be allowed to treat the child care expenses as a cost of earning income, provided the parent who has custody for the shorter period does not claim such expenses.

The Congress also viewed the bar on deducting payments to relatives for the care of children as overly restrictive. Relatives generally provide superior attention. In order to cover the child care expenses paid to relatives and also to limit the risks of abuse (such as splitting or transferring income by gift to relatives who are in lower brackets or have incomes below taxable levels) the Congress has provided the child care allowance only for those payments made to a relative who is not the taxpayer's dependent and whose services constitute employment for social security purposes.

The Congress views qualified child care expenses principally as a cost of earning income, but believes that in view of the disparity of benefits between high-income and low-income taxpayers and the large revenue cost of a deduction (in determining adjusted gross income) that a tax credit is more appropriate. It also believes that an income ceiling on those entitled to the allowance has minimal revenue impact if the allowance is in the form of a credit. Therefore, it considered it appropriate and feasible to eliminate the income phaseout and to allow all taxpayers to claim such expenses regardless of their income level.

Explanation of provision

The Act replaces the itemized deduction for household and dependent care expenses with a nonrefundable income tax credit. Taxpayers with qualified expenses may claim a credit against tax for 20 percent of the expenses incurred (up to certain limits) for the care of a child under age 15 or for an incapacitated dependent or spouse, in order to enable the taxpayer to work. The prior income limit of $35,000 beyond which the deduction was phased out is removed.

Although the Act changes the nature of a claim for child care expenses to a credit, it retains the basic rules for determining qualified expenses with some modifications and extensions.

Several changes simplify the child care tax form. One such change replaces the present monthly maximum allowance for expenses for children outside the home ($200 for one dependent, $300 for two dependents, and $400 for three or more dependents) with an annual credit of 20 percent of a maximum of $2,000 for one dependent and $4,000 for two or more dependents whether the expenses are for services inside or outside the home. (No credit, however, is allowed for the expenses for the care of a dependent over age 14 or of a spouse outside the home.) With a 20-percent credit, the maximum credit would be $400 for one dependent and $800 for two or more.

The Act also extends the credit to married couples where the husband or wife, or both, work part-time. (Previously, both were required to work full-time.) The eligible expenses are limited to the amount of earnings of the spouse earning the smaller amount or, in the case of a single person, to his or her earnings. The deduction also is made available to married couples where one is a full-time student and the other spouse works. For purposes of the earnings limitation only, the Act treats a student as if he or she earns $166 a month if there is one dependent and $333 a month if there are two or more dependents at any time during the year.

The credit is available to married couples only if they file a joint return. The credit is extended to a divorced or separated parent who has custody of a child under age 15 even though the parent may not be entitled to a dependency exemption for the child, provided the parent claiming the credit has custody of the child for a longer period during the year than the other parent and maintains (i.e., provides over half the cost of maintaining) a household which includes the child. A deserted spouse is eligible for the credit when the deserting spouse is absent for the last 6 months of the taxable year instead of an entire year. Finally, the requirement that the allowable expenses be reduced by disability income received by the dependent is eliminated.

The entire allowance of $2,000 or $4,000 a year is available to a taxpayer who has one or two qualifying dependents, respectively, at any time during the course of the taxable year. However, only those expenses incurred on behalf of a qualifying individual during the period when the individual was a qualifying individual are eligible. For example, a taxpayer whose child reaches age 15 in April would be eligible for the entire $2,000 limit and no prorating would be required. However, only those expenses incurred prior to the child's fifteenth birthday would be eligible.

The Act repeals the disqualification of any amounts paid to relatives. The Act allows a credit for child care expenses paid to relatives who are not dependents of the taxpayer even if they are members of the taxpayer's household, provided the relative's services constitute employment within the meaning of section 3121(b), that is, for social security purposes.[1]

The Act also makes a conforming change to allow the credit to be considered for purposes of additional withholding allowances. Under prior law (sec. 3402(m)(2)), additional withholding allowances were permitted to be claimed for itemized deductions. Changing the child care provision from a deduction to a tax credit would have made it impossible for an employee to avoid the overwithholding attributable to the child care expenses. To avoid this overwithholding, the Act gives the Secretary of the Treasury the authority to provide withhold-

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[1] For social security purposes, the following services are considered employment: (a) services in the taxpayer's home if performed by the taxpayer's son or daughter age 21 or over, but not the taxpayer's spouse; (b) domestic service by the taxpayer's mother or father if (i) the taxpayer has in his home a son or daughter who is under age 18 or who has a physical or mental condition requiring the personal care of an adult for at least four continuous weeks in the quarter, and (ii) the taxpayer is a widow or widower or is divorced, or the taxpayer has a spouse in his home who, because of a physical or mental condition, is incapable of caring for his son or daughter for at least four continuous weeks in the quarter; (c) services of all other relatives.

ing allowance tables which take into account tax credits to which employees are entitled. It is intended that these tables may take into account the credit for child care expenses, the new tax credit for the elderly, and such other tax credits as the Secretary may find appropriate. Because the credit for child care expenses is 20 percent of the eligible expenses, the tables may be designed to reflect the approximate tax value of the credit rather than the total expenses (as is the case with itemized deductions) to make the withholding change closely approximate the reduction in tax liability. (Similarly, the full amount of the tax credit for the elderly might not be reflected in such tables, particularly where the income phaseout is operative.)

It is estimated that the number of returns benefiting from the child care provision will approximately double from about 2 million to nearly 4 million. Of the 4 million, approximately 3 million will benefit compared to prior law and about 1 million will lose relatively small amounts because of the change from an itemized deduction to a 20-percent credit.

Effective date

This provision is to apply to taxable years beginning after December 31, 1975.

Revenue effect

This provision will reduce tax receipts by $384 million in fiscal year 1977, $368 million in fiscal year 1978, and $488 million in fiscal year 1981.

5. Sick Pay and Certain Military, etc. Disability Pensions (sec. 505 of the Act and secs. 104 and 105 of the Code)

a. Sick Pay

Prior law

Under prior law, gross income did not include amounts received under wage continuation plans when an employee was "absent from work" on account of personal injuries or sickness. The payments that were received when an employee was absent from work were generally referred to as "sick pay" (under sec. 105(d)).

The proportion of salary covered by the wage continuation payments and any hospitalization of the taxpayer determined whether or not there was a waiting period before the exclusion applied. If the sick pay was more than 75 percent of the regular weekly rate, the waiting period before the exclusion became available was 30 days whether or not the taxpayer was hospitalized during the period. If the rate of sick pay was 75 percent or less of the regular weekly rate and the taxpayer was not hospitalized during the period, the waiting period was 7 days. If the sick pay was 75 percent or less of the regular weekly rate and the taxpayer was hospitalized for at least 1 day during the period, there was no waiting period and the sick pay exclusion applied immediately. In no case could the amount of "sick pay" exclusion exceed $75 a week for the first 30 days and $100 a week after the first 30 days.

During the period that a retired employee was entitled to the sick pay exclusion, he could not recover any of his contributions toward any annuity under section 72.[1]

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[1] Reg. sec. 1.72–15 (b) and (c)(2) and 1.72–4(b)(2)(iv).

Reasons for change

Section 105(d), which provided the exclusion for "sick pay," was extremely complex. The provision's complexity required a separate 28-line tax form which was so difficult that many taxpayers had to obtain professional assistance in order to complete it and avail themselves of the exclusion. The Congress believed that elimination of the complexity in this area was imperative.

In addition, the sick pay provision caused some inequities in the tax treatment of sick employees compared to working ones and the treatment of lower-income taxpayers compared to those with higher incomes. Excluding "sick pay" payments (received in lieu of wages) from income when an employee was absent from work, while taxing the same payments if made as wages while he was at work, was not justified. A working employee generally incurs some costs of earning income not incurred by a sick employee who stays at home. The latter may incur additional medical expenses on account of his sickness, but he may deduct such medical expenses if they exceed the percentage of income limitations.

Under prior law, low- and middle-income taxpayers received on a percentage basis less benefit from the sick pay exclusion than did taxpayers in higher marginal tax brackets because of the progressivity of tax rates. Taxpayers who received no sick pay, of course, received no benefit at all. The Congress believed that the exclusion allowed under section 105 should not have a regressive effect and that the provision should direct a fairer share of its tax benefits to low- and middle-income taxpayers.

Explanation of provision

The Act repeals the prior sick pay exclusion and continues the maximum exclusion of $100 a week ($5,200 a year) only for taxpayers under age 65 who have retired on disability and are permanently and totally disabled. For this purpose permanently and totally disabled means unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months. A taxpayer is considered to be "retired" even if not formally placed on retirement but receiving some other form of income in lieu of wages, such as accumulated leave, provided he is not expected to return to work. The Congress expects that proof of disability must be substantiated by the taxpayer's employer, who is to certify this status under procedures approved in advance by the Internal Revenue Service. The Service may also issue regulations requiring the taxpayer to provide proof from time to time that he is disabled. If, at the time an individual retires on disability, a qualified physician is not certain that the retiree's disability will in fact be permanent, the Service may accept subsequent evidence that his disability was permanent and qualified him as of the time of his retirement for this provision. (At age 65, taxpayers become ineligible for this exclusion but are entitled to claim the revised elderly credit.)

The maximum amount excludable is to be reduced on a dollar-for-dollar basis by the taxpayer's adjusted gross income (including disability income) in excess of $15,000. Thus, if a taxpayer receives

$5,200 in disability income and $15,000 (or more) in other income which together equal $20,200 (or more), he would not be entitled to any exclusion of his disability payments.

In order to claim this exclusion, a taxpayer who is married at the close of a taxable year must file a joint return with his or her spouse, unless they have lived apart at all times during that year. Each spouse is entitled to a separate, maximum $5,200 exclusion, but the phaseout for adjusted gross income in excess of $15,000 applies on a per-return basis.

The Act also provides a transitional rule allowing persons who, before January 1, 1976, retired on disability or who were entitled to retire on disability, and on January 1, 1976, were permanently and totally disabled (though they may not have been permanently and totally disabled on their retirement date) to claim a disability income exclusion if they otherwise qualify. Another transitional rule allows taxpayers who retired on disability before January 1, 1976, and who were entitled to a sick pay exclusion on December 31, 1975, also to benefit from the section 72 annuity exclusion before age 65, if they make an irrevocable election not to claim the disability exclusion.

The Act provides that when a taxpayer reaches age 65, he can begin to recover his investment in an annuity contract (if any) under section 72. A special rule enables certain permanently and totally disabled taxpayers who determine that they will not be able to claim any (or little) sick pay exclusion to benefit from the section 72 exclusion before age 65. Under this rule, the taxpayer may make an irrevocable election not to seek the benefits of the disability income exclusion for that year or subsequent years.[2]

The new rules apply both to civilians and to military personnel. However, Veterans' Administration payments remain completely exempt from tax.

Effective date

This provision applies to taxable years beginning after December 31, 1975.

b. Disability Pensions of the Military, etc.

Prior law

Prior law excluded from gross income amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country, as well as similar amounts received by disabled members of the National Oceanic and Atmospheric Administration (NOAA, formerly called the Coast and Geodetic Survey), the Public Health Service, or the Foreign Service (sec. 104(a)(4)).[3]

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[2] At age 65 the taxpayer then becomes eligible for the elderly credit rather than having to wait until mandatory retirement age as was the case under prior law. Public retirees who retired on disability and make this election must wait until minimum retirement age to use the retirement income credit (rather than the mandatory age of prior law). Otherwise, public retirees who retired on disability would be eligible for the retirement income credit at a substantially earlier time than under prior law. Congress did not intend this substantial liberalization of the retirement income credit for public retirees.

[3] Under Treasury regulations (Reg. sec. 1.105—4(a)(3)(i)(a)), the portion of a disability pension received by a retired member of the Armed Forces which was in excess of the amount excludable under this provision was excluded as sick pay under a wage continuation plan subject to the limits of section 105(d) if such pay was received before the member reached retirement age. This Act repeals the sick pay provision and substitutes a maximum annual exclusion of $5,200 for persons who are permanently and totally disabled. (See Explanation of provisions under *a. Sick Pay* above.)

Reasons for change

The Congress was concerned with two somewhat conflicting aspects of the exclusion of disability payments from gross income: on the one hand, the abuse of the exclusion in certain instances, particularly by retiring members of the armed forces, and on the other hand, the expectation and reliance of present members of the affected government services, especially the armed forces, on the government benefits available to them when they entered government employment or enlisted in or were drafted into the military.

Criticism of the exclusion of armed forces disability pensions from income focused on a number of cases involving the disability retirement of military personnel. In many cases, armed forces personnel have been classified as disabled for military service shortly before they would have become eligible for retirement principally to obtain the benefits of the special tax exclusion on the disability portion of their retirement pay. In most of these cases the individuals, having retired from the military, earn income from other employment while receiving tax-free "disability" payments from the military. The Congress questioned the equity of allowing retired military personnel to exclude the payments which they receive as tax-exempt disability income when they are able to earn substantial amounts of income from civilian work, despite disabilities such as high blood pressure, arthritis, etc.

However, in order to provide benefits to any present personnel who may have joined or continued in the government or armed services in reliance on possible tax benefits from this program, the Congress believed any changes in the tax treatment of military disability payments should affect only future members of the armed forces, NOAA, Public Health Service and Foreign Service. The Congress also believed that the risks borne by some civilian employees of the United States Government are similar to those faced in combat by the military. It thus decided to extend tax exclusion benefits to civilian government employees who receive disability pay for injuries resulting from acts of terrorism.

Explanation of provisions

The Act eliminates the exclusion of disability payments from income for those covered under section 104(a)(4), that is, members of the armed forces of any country, NOAA, the Public Health Service and the Foreign Service. This change applies only prospectively to persons who join these government services after September 24, 1975. Specific exceptions continue the exclusion in certain cases for future disability payments for injuries and sickness resulting from active service in the armed forces of the United States.

At all times, Veterans' Administration disability payments will continue to be excluded from gross income. In addition, even if a future serviceman who retires does not receive his disability benefits from the Veterans' Administration, he will be allowed to exclude from his gross income an amount equal to the benefits he could receive from the Veterans' Administration. Otherwise, future members of the armed forces will be allowed to exclude military disability retirement payments from their gross income only if the payments are directly related to "combat injuries." A combat-related injury is defined as an injury or sickness which is incurred as a result of any one of the following activities: (1) as a direct result of armed conflict; (2) while engaged in extra-hazardous service, even if not directly engaged in combat; (3) under conditions simulating war including maneuvers or training; or which is (4) caused by an instrumentality of war, such as weapons. This definition of combat-related injuries is meant to cover an injury or sickness attributable to the special dangers associated with armed conflict or preparation or training for armed conflict.

In addition, the Act provides an exclusion for disability payments to civilian employees of the United States Government for injuries which result from acts of terrorism and which are incurred while the employees are performing official duties outside the United States.

All persons who were members of the armed forces of any country (or a military reserve unit), the National Oceanic and Atmospheric Administration, the Public Health Service and the Foreign Service as of September 24, 1975, or who as of that date were subject to a written binding commitment to enter these Government services or were retirees from these services receiving disability retirement payments which were excluded from their gross income under prior law, will continue to exclude such payments from gross income under the Act. In addition, all disability benefits paid by the Veterans' Administration will continue to be exempt from tax, as under prior law.

Effective date

This provision relating to members of the armed forces of any country, the National Oceanic and Atmospheric Administration, the Public Health Service and the Foreign Service applies to persons who joined these services after September 24, 1975. The exclusion for disability payments for injuries resulting from acts of terrorism applies to taxable years beginning after December 31, 1976.

Revenue effect

The change in the sick pay provision will increase tax receipts by $380 million in fiscal year 1977, $357 million in fiscal year 1978, and $450 million in 1981. The changes in the disability exclusion will have no revenue impact until substantial numbers of persons entering government service after September 24, 1975, retire. The new exclusion for disability payments for injuries resulting from acts of terrorism will cause a negligible revenue loss.

6. Moving Expenses (sec. 506 of the Act and secs. 217 and 82 of the Code)

Prior law

An employee or self-employed individual may claim a deduction from gross income for certain expenses of moving to a new residence in connection with beginning work at a new location (sec. 217). Any amount received directly or indirectly as a reimbursement of moving expenses must be included in a taxpayer's gross income as compensation for services (sec. 82), but he may offset this income by deducting expenses which would otherwise qualify as deductible items.

Deductible moving expenses are the expenses of transporting the taxpayer and members of his household, as well as his household goods and personal effects, from the old to the new residence; the cost of meals and lodging enroute; the expenses for premove househunting trips; temporary living expenses for up to 30 days at the new job location; and certain expenses related to the sale or settlement of a lease on the old residence and the purchase of a new one at the new job location.

The moving expense deduction was subject to a number of limitations under prior law. A maximum of $1,000 could be deducted for premove househunting and temporary living expenses at the new job location. A maximum of $2,500 (reduced by any deduction claimed for househunting or temporary living expenses) could be deducted for certain qualified expenses for the sale and purchase of a residence or settlement of a lease. If both a husband and wife began new jobs in the same general location, the move was treated as a single commencement of work. If a husband and wife filed separate returns, the maximum deductible amounts were halved.

Also, under prior law in order for a taxpayer to claim a moving expense deduction, his new principal place of work had to be at least 50 miles farther from his former residence than was his former principal place of work (or his former residence, if he had no former place of work). During the 12-month period following his move, the taxpayer had to be a full-time employee in the new general location for at least three-fourths of the following year, that is, 39 weeks during the next 12-month period. A self-employed person was required, during the 24-month period following his arrival at his new work location, to perform services on a full-time basis for at least 78 weeks, with at least 39 weeks of full-time work falling within the first 12 months. Even if the 39- or 78-week requirement had not been fulfilled at the end of a taxable year (but could still be fulfilled), the taxpayer could elect to deduct any qualified moving expenses which he had paid or incurred provided he met all the other requirements. If he failed to meet the full-time employment period requirement in a subsequent taxable year, he had to include the amounts previously deducted in his gross income for the subsequent year.[1]

Pursuant to statutory autorization,[2] the Secretary of the Treasury had entered into agreements with the Secretary of Defense for members of the Army, Navy, and Air Force, and with the Secretary of Transportaion for members of the Coast Guard to allow special treatment for servicemen's moving expenses for taxable years ending before January 1, 1976.

As a result, the Secretaries of Defense and Transportation were not required to report or withhold tax on moving expense reimbursements made to members of the armed forces, nor were members of the armed forces required to include in income the value of in-kind moving services provided by the military. However, members of the armed forces could deduct moving expenses to the extent they exceeded military reimbursements, and would otherwise qualify as deductible expenditures under section 217, without counting any military in-kind reimbursements against the dollar limitations. This special legislative moratorium on the application of the moving expense provision to members of the military lapsed as of January 1, 1976.

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[1] The 39- and 78-week tests were waived if the employee was unable to satisfy them as a result of death, disability, or involuntary separation (other than for willful misconduct).

[2] Public Law 93–490, sec. 2, 88 Stat. 1466. 93d Cong., 2d sess., October 26, 1974.

Reasons for change

The prior provisions for moving expenses reflected significant revisions made by the Tax Reform Act of 1969. Generally, the Congress believes that the basic rationale and requirements of these provisions remain sound.

The mobility of labor continues to be important to the economy of the United States. Frequently, employers must transfer employees from one location to another and workers must change their residence in order to obtain better employment opportunities. The substantial moving expenses incurred by many taxpayers in connection with employment-related moves may be viewed as a cost of earning income. Allowing a tax deduction for certain moving expenses helps achieve a more accurate account of a taxpayer's net income.

Despite inflation between 1969 and 1975, there had been no adjustment of the $1,000 and $2,500 ceilings on moving expense deductions. The Congress believed that these ceilings should be set at higher dollar levels. However, the Congress did not believe that the two ceilings had to be increased proportionately.

The 50-mile test restricted the deduction of expenses to a move to a new job location which was at least 50 miles farther from the taxpayer's former residence than was his former principal place of work. For example, if a taxpayer's former residence was 30 miles from his former job, his new job location had to be at least 50 miles farther from his former residence; that is, it had to be a total of at least 80 miles, if his moving expenses were to be deductible. Recognizing the increasing cost of commuting, the growing concern for gasoline conservation, and the continuing inadequacy of mass transportation in most areas of the country, the Congress decided that some reduction of the 50-mile test was appropriate.

Certain changes made in the 1969 Act created unforeseen administrative difficulties for the military. The Department of Defense and the Department of Transportation (with respect to the peacetime Coast Guard) apparently have no economically feasible procedure for identifying or valuing the in-kind reimbursements provided for each serviceman where the military pays a mover for the moving expenses, or does the moving itself. The Department of Defense, acting on behalf of all the military services, indicated in discussions with the Internal Revenue Service that establishing such a system for identifying reimbursed moving expenses and in-bound services would involve substantial administrative burdens for the Department, as well as increasing its expenses, at no revenue gain to the Treasury. As a result of these administrative problems, the Internal Revenue Service in 1971 agreed to a moratorium for the reporting and reimbursement rules (except for cash reimbursements) in the case of the military. The Service extended this administrative moratorium through 1972 and 1973. As indicated above, in 1974 the armed forces were exempted from these requirements by legislation effective through December 31, 1975.

The Congress agreed that requiring the military to report and withhold tax on reimbursed in-kind moving expenses and requiring servicemen to include reimbursements or allowances for moving expenses in income would entail needless, costly administration by the military services.

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In addition, the military had found the mileage limitation (the 50-mile limit) and the 39-week rule a hardship for military personnel because many mandatory personnel moves are for less than 39 weeks and for less than 50 miles. The Congress believed that servicemen who are required to change their residence incident to a permanent change of station should not be required to include in income the in-kind moving assistance, allowances, or reimbursements provided by the military and should not be denied a deduction for otherwise deductible expenses involved in a mandatory move only because they fail the time and mileage tests. Therefore, the Congress exempted members of the armed forces from the time and mileage limitations for moves incident to a permanent change of station when the military authorizes in-kind moving assistance. The Congress also believed it appropriate to exclude from income the in-kind moving services and assistance provided to move servicemen's spouses and dependents in connection with moves required by the military.

Explanation of provision

The Act modifies the prior treatment of job-related moving expenses in a number of respects. It increases the maximum deduction for premove househunting and temporary living expenses at the new job location from $1000 to $1500 and increases from $2500 to $3000 the maximum deduction for qualified expenses for the sale, purchase or lease of a residence (reduced by any deduction claimed for premove househunting or temporary living expenses). As with the existing limitations, the new amounts are halved if a husband and wife file separate returns. The Act also reduces the 50-mile rule to 35 miles.

With regard to military moves, the Act also exempts military moves from the time and mileage requirements and excludes from income cash reimbursements or allowances to the extent of expenses actually paid or incurred, as well as all in-kind services provided by the military. The Armed Services are exempted from the reporting requirements under section 82 with regard to in-kind moving services (including storage), reimbursements and allowances provided to members on active duty for moves pursuant to military orders and incident to a permanent change of station. In addition, the Act provides that when a military member is required to relocate and the member's spouse and dependents move to a different location, all in-kind moving and storage expenses, and reimbursements and allowances (to the extent of moving expenses actually paid or incurred) provided by the military to move the member and the spouse and dependents to and from their separate locations are excluded from income. In cases where the military moves the member and the member's spouse and dependents to or from separate locations and they incur unreimbursed expenses, their moves are treated as a single move to a new principal place of work for purposes of section 217.

Effective date

This provision is to apply generally to taxable years beginning after December 31, 1976, except that the military provisions are to apply for years beginning after 1975.

Revenue effect

This provision will reduce budget receipts by $7 million in fiscal year 1977, $47 million in fiscal year 1978, and $62 million in fiscal year 1981.

7. Tax Simplification Study by Joint Committee (sec. 507 of the Act)

Prior law

Prior law contained no provision requiring a specific report on tax simplification by the Joint Committee. However, the law (sec. 8022 of the Code) provides that the Joint Committee on Taxation is to investigate the operation and effects of the Federal system of internal revenue taxes, including studies for the simplification of the income tax. The Joint Committee is to publish its proposals and report the results and any recommendations to the Senate Finance and House Ways and Means Committees.

Reasons for change

The Congress believes that simplification of the Code is urgent and that the Joint Committee should make a specific study involving ways of simplifying and indexing the tax laws.

Explanation of provision

The Act requires the Joint Committee to conduct a study on "simplifying and indexing the tax laws" (including whether tax rates can be reduced by repealing any or all tax deductions, exemptions or credits). A report of its study and investigation together with its recommendations, including recommendations for legislation, is to be submitted to the Senate Finance and House Ways and Means Committee by June 30, 1977.

Revenue effect

This provision will not have any revenue effect.

E. BUSINESS-RELATED INDIVIDUAL INCOME TAX REVISIONS

1. Deductions for Expenses Attributable to Business Use of Home (sec. 601 of the Act and new sec. 280A of the Code)

Prior law

Under the code, no deductions are allowed for personal, living, and family expenses except as expressly allowed under the code (sec. 262). Generally, under this provision, expenses and losses attributable to a dwelling which is occupied by a taxpayer as his personal residence are not deductible. However, deductions for interest, certain taxes, and casualty losses attributable to a personal residence are expressly allowed under other provisions of the tax laws (secs. 163, 164 and 165). Under prior law, if a portion of the residence was used in the taxpayer's trade or business or for the production of income, a deduction would be allowed for an allocable portion of the expenses incurred in maintaining such personal residence.

In any case involving the business use of a personal residence, it must first be established that the expenses were incurred in carrying on a trade or business (sec. 162) or for the production of income (sec. 212). Thus, there must be some relatively clear connection between the activities conducted in the home and a trade or business or the production of income. Under the regulations (Reg. § 1.262–1(b)(3)), the expenses of maintaining a household are treated as nondeductible personal expenses if the taxpayer only incidentally conducts business in his home. However, under prior law, if a part of the house is used as the taxpayer's place of business, the allocable portion of the expenses attributable to the use of the home as a place of business was allowed as a deduction.

For this purpose the expenses attributable to the office or business use of the home were deductible if they were "ordinary and necessary" expenses paid or incurred in carrying on a trade or business or for the production of income. These expenses were claimed as deductions by self-employed individuals who used portions of their residences for trade or business purposes, employees who maintained offices in connection with the performance of their duties as employees, or investors who maintained offices in connection with investment activities. Typically, the expenses for which a deduction was claimed included an allocable portion of the depreciation or rent, maintenance, utility, and insurance expenses incurred in connection with the residence.

With respect to the maintenance of an office in an employee's home, the position of the Internal Revenue Service was that the office must be required by the employer as a condition of employment and regularly used for the performance of the employee's duties. (Revenue Ruling 62–180, 1962–2 C.B. 52, set forth these standards as they applied to the deductibility of expenses attributable to an office maintained in an employee's home.) Certain courts had decided that a more liberal standard than that urged by the Internal Revenue Service was appropriate. Under these decisions, the expenses attributable to an office maintained in an employee's residence were deductible if the maintenance of the office was "appropriate and helpful" to the employee's business: *George H. Newi*, T.C. Memo. 1969–131, aff'd 432 F. 2d 998 (2d Cir. 1970); *Jay R. Gill*, T.C. Memo. 1975–3; *Hall* v. *United States*, 387 F. Supp. 612 (D.C. N.H., 1975).

In *Stephen A. Bodzin*, 60 T.C. 820 (1973), the Tax Court, in a decision allowing a deduction for an office in an employee's residence, held that "the applicable test for judging the deductibility of home office expenses is whether, like any other business expense, the maintenance of an office in the home is appropriate and helpful under all the circumstances." However, the court cautioned that no deduction would be allowable if personal convenience were the primary reason for maintaining the office notwithstanding any conclusion as to the "appropriateness" and "helpfulness" of the office. On appeal, the Fourth Circuit reversed the decision of the Tax Court (509 F.2d 679). The Appellate Court held that, as a factual matter, the expenses attributable to the taxpayer's residence were nondeductible personal expenses and that it was therefore unnecessary to decide if the maintenance of the office was appropriate and helpful in carrying on his business. Thus, it was not clear which standard would be applied in the Fourth Circuit in a case in which the court found both personal and business use of a residence. However, the court suggested that to obtain a deduction, an employee would have to show that the office provided by the employer is not available at the times the employee uses the office in his residence or that the employer's office is not suitable for the purposes for which the taxpayer is using the office in his residence.[1]

The Tax Court had also applied the "appropriate and helpful" standard to determine the deductibility of expenses attributable to the maintenance of an office in the home of an investor. (*Lena M. Anderson*, TC Memo 1974–49.) In that case, the taxpayer was allowed a portion of the expenses attributable to a family room which was partially used to conduct investment activities which consisted of keeping records with respect to rental properties, preparing the taxpayer's income tax returns, and writing letters to brokers and taxing authorities.

With respect to an apartment or residence used by a taxpayer while in a travel status, the expenses attributable to the maintenance of the apartment or residence are treated as lodging expenses subject to certain other rules relating to deductibility (sec. 162). As such, the expenses are deductible only if they are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it. "Lavish or extravagant" expenses are not allowable deductions. The expenses attributable to the apartment or house are deductible as lodging expenses if properly allocable to the taxpayer's trade or business even though the transportation expenses are not deductible because the trip was undertaken primarily for personal purposes.

Additional requirements also apply with respect to a residence where the business use consists of entertainment of clients, customers, or

[1] The Supreme Court denied certiorari in the *Bodzin* case on October 6, 1975 (44 U.S.L.W. 3201).

business associates. In such cases, the residence is treated as an entertainment facility, and no deduction is allowed for any expenditure unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the items of expense were directly related to the active conduct of such trade or business (sec. 274).

In determining whether or not an entertainment facility was used primarily for the furtherance of the taxpayer's trade or business, the taxpayer must establish that the primary use of the facility was for ordinary and necessary business use based upon the facts and circumstances considered on a case-by-case basis. Generally, the actual use of the facility is controlling, and not its availability for use. The factors to be considered include the nature of each use, the frequency and duration of business use and the amount of expenditures incurred for business purposes.

The regulations provide that with respect to an entertainment facility, a taxpayer shall be deemed to have established that an entertainment facility was used primarily for the furtherance of his trade or business if more than 50 percent of the total calendar days of use of the facility during any taxable year were business use days.

An expenditure is considered directly related to the active conduct of the taxpayer's trade or business if four requirements are met: (1) the taxpayer had more than a general expectation of deriving income or benefit (other than goodwill) at some indefinite future time; (2) the taxpayer actually engaged in, or reasonably expected to engage in, business meetings, negotiations, etc., for the purpose of obtaining income or other benefits; (3) in light of all the facts and circumstances, the principal function of the combined business meeting, etc., and entertainment was the active conduct of the taxpayer's trade or business, and (4) the expenditure was allocable to the taxpayer and person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment.

In determining the deductible amount attributable to the business use of the home, the general rule is that any reasonable method of allocation may be used. In all cases involving the dual use of a home, the allocation of expenses attributable to the portion of the residence used for business purposes will take into account the space used for those purposes, e.g., a percentage of the expenses based on the square feet of that portion compared to the total square feet of the residence. In addition, a further allocation based on time of use is required when the portion of the residence is not exclusively used for business purposes. In Rev. Rul. 62–180, 1962–2 C.B. 52, 54, the Internal Revenue Service held that, after allocating expenses attributable to a den used for business and personal purposes on the basis of space, a further allocation must be made on the basis of time of use to reflect the dual use. For purposes of the latter allocation, the Service ruled that the allocation should be made on the basis of availability for use rather than actual use, i.e., the ratio of time actually used for business purposes to the total time it is available for all uses. However, in *Goerge W. Gino*, 60 T.C. 304, 314 (1973) (followed in *Lena M. Anderson*, T.C. Memo, 1974–49), the Tax Court held that such expenses should be allocated on the basis of actual business use as compared with actual total use.

In another case where the allocation could not clearly be determined, the *Cohan* rule was applied to estimate the approximate space of an apartment which was used for business purposes. *George H. Newi*, T.C. Memo. 1969–131, aff'd., 432 F.2d 998 (2d Cir. 1970). The *Cohan* rule provides, generally, that where there is evidence that the taxpayer incurred certain deductible expenses but the exact amount cannot be determined, a close approximation would be acceptable and, therefore, the deduction would not be entirely disallowed. Under present law, however, because of certain substantiation requirements, no deduction is allowed for certain expenditures relating generally to travel or entertainment on the basis of a *Cohan* approximation or on the basis of unsupported testimony of the taxpayer.

Reasons for change

The Congress believed that there was a great need for definitive rules to resolve the conflict that existed between several court decisions and the position of the Internal Revenue Service as to the correct standard governing the deductibility of expenses attributable to the maintenance of an office in the taxpayer's personal residence.

With respect to the "appropriate and helpful" standard employed in the court decisions, the determination of the allowance of a deduction for these expenses was necessarily a subjective determination. In the absence of definitive controlling standards, the "appropriate and helpful" test increased the inherent administrative problems because both business and personal uses of the residence were involved and substantiation of the time that the space was used for each of these activities was clearly a subjective determination. In many cases the application of the appropriate and helpful test appeared to result in treating personal living; and family expenses which are directly attributable to the home (and therefore not deductible) as ordinary and necessary business expenses, even though those expenses did not result in additional or incremental costs incurred as a result of the business use of the home. Thus, expenses otherwise considered nondeductible personal, living, and family expenses might be converted into deductible business expenses simply because, under the facts of the particular case, it was appropriate and helpful to perform some portion of the taxpayer's business in his personal residence. For example, if a university professor, who was provided an office by his employer, used a den or some other room in his residence for the purpose of grading papers, preparing examinations or preparing classroom notes, an allocable portion of certain expenses might have been claimed as a deduction even though only minor incremental expenses were incurred in order to perform these activities.

Explanation of provision

The Act adds a new section to the Code (sec. 280A) which provides, in part, that no deductions shall be allowed with respect to a dwelling unit which is used by the taxpayer as a residence, unless specifically excepted from this new section and otherwise allowable. The provisions of this section apply to individuals, trusts, estates, partnerships, and electing small business corporations. This provision does not apply to a corporation (other than an electing small business corporation).

The general disallowance provision, however, does not apply with respect to certain expenses which are otherwise allowable as deductions; for example, the deductions allowable for interest (sec. 163), certain taxes (sec. 164) and casualty losses (sec. 165) may still be claimed as deductions without regard to their connection with the taxpayer's trade or business or income producing activities.

In the case of a taxpayer (other than an employee) who exclusively uses a portion of a dwelling unit on a regular basis as his principal place of business, as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or in the case of a separate structure which is not attached to the dwelling, in connection with the taxpayer's trade or business, an allocable portion of ordinary and necessary trade or business expenses paid or incurred in connection with such trade or business use will be allowed as a deduction. However, the amount of the deduction is subject to a limitation discussed below.

Exclusive use of a portion of a taxpayer's dwelling unit means that the taxpayer must use a specific part of a dwelling unit solely for the purpose of carrying on his trade or business. The use of a portion of a dwelling unit for both personal purposes and for the carrying on of a trade or business does not meet the exclusive use test. Thus, for example, a taxpayer who uses a den in his dwelling unit to write legal briefs, prepare tax returns, or engage in similar activities, as well for personal purposes, will be denied a deduction for the expenses paid or incurred in connection with the use of the residence which are allocable to these activities.

Under the Act, an exception to the exclusive use test is provided in the case of a taxpayer whose trade or business is selling products at retail or wholesale and whose dwelling unit is the sole fixed location of such trade or business. Under this exception, the ordinary and necessary expenses allocable to space (within a dwelling unit) which is used as a storage unit for inventory will not be disallowed. However, the space must be used on a regular basis and must be a separately identifiable space suitable for storage.

In addition to the exclusive use test, the Act requires that the portion of the residence used for trade or business purposes must be used by the taxpayer on a regular basis in order for the allocable portion of the expenses to be deductible. Expenses attributable to incidental or occasional trade or business use of an exclusive portion of a dwelling unit would not be deductible.

The provision does not permit a deduction for any portion of expenses paid or incurred with respect to the use of a dwelling unit which is used by the taxpayer both as a residence and in connection with income producing activities (sec. 212). For example, no deduction will be allowed if a taxpayer who is not in the trade or business of making investments uses a portion of his residence (exclusively and on a regular basis) to read financial periodicals and reports, clip bond coupons and perform similar activities because the activity is not a trade or business.

In the case of an employee, a deduction for the portion of the ordinary and necessary business expenses attributable to the use of a residence which are paid or incurred in connection with the performance of services as an employee will be allowable only if, in addition to satisfying the exclusive and regular use tests, the use is for the convenience of his employer. If the use is merely appropriate and helpful, no deduction attributable to such use will be allowable.

The Act also provides an overall limitation on the amount of deductions that a taxpayer may take for the business use of the home. The allowable deductions attributable to the use of a residence for trade or business purposes may not exceed the amount of the gross income derived from the use of the residence for that trade or business reduced by the deductions which are allowed without regard to their connection with the taxpayer's trade or business (e.g., interest and taxes). In the case where gross income is derived both from the use of the residence and from the use of facilities other than the residence, a reasonable allocation (based on the facts and circumstances of each case) is to be made to determine that portion of the gross income derived from the use of the residence. With respect to the deductions which are allocable to the trade or business use of the residence, deductions allowable without regard to whether the activity is a trade or business are to be deducted first. Any remaining gross income may then be reduced (but not below zero) by the remaining allowable deductions which are allocable to such use.

Effective date

This provision applies to taxable years beginning after December 31, 1975.

Revenue effect

The revenue effect of this provision is combined with that of the following vacation home provisions.

2. Deduction for Expenses Attributable to Rental of Vacation Homes (sec. 601 of the Act and sec. 280A of the Code)

Prior law

A taxpayer is allowed a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business (sec. 162), or for the management, conservation, or maintenance of property held for the production of income (sec. 212). In order to be entitled to a deduction under these provisions, it is necessary that the activity be engaged in by the taxpayer for profit (i.e., for the purpose of or with the intention of making a profit.)[1] The determination of whether an activity is engaged in for profit is to be made on the basis of objective standards, taking into account all facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances (without regard to the taxpayer's subjective intent) must indicate that the taxpayer entered into or continued the activity with the objective of making a profit. No deduction is allowed under section 162 or 212 if the activity is carried on primarily as a sport, hobby, or for recreation.

Even though an activity is not engaged in for profit (and therefore no deduction is allowed under section 162 or 212), certain deductions

[1] See *Morton* v. *Commissioner*, 174 F. 2d 302, 304 (2d Cir.), cert. denied, 338 U.S. 828 (1949); *Schley* v. *Commissioner*, 375 F. 2d 747 (2d Cir. 1967); and *George W. Mitchell*, 47 T.C. 120 (1966).

are allowed under other provisions of the tax law. Subject to specific limitations discussed below, a deduction is allowed under section 183 for expenditures which are of the type that may be deducted without regard to whether they are incurred in connection with a trade or business or for the production of income. These items include the deductions which are allowed for interest (sec. 163), certain State and local property taxes (sec. 164), and casualty losses (sec. 165).

Section 183 further provides that, in the case of an activity not engaged in for profit, a deduction is allowed for expenses which could be deducted if the activity were engaged in for profit, but only to the extent these expenses do not exceed the amount of gross income derived from the activity reduced by the deductions which are allowed in any event (e.g., interest and certain State and local taxes). In other words, as to expenses such as depreciation, insurance, and maintenance, a taxpayer is allowed a deduction but only to the extent of income derived from the activity. The taxpayer is not allowed to use these deductions to create losses which can be used to offset other income.

A taxpayer is presumed to be engaged in an activity for profit for a taxable year if, in two or more years of the period of five consecutive taxable years (seven consecutive taxable years in the case of an activity which consists in major part of the breeding, training, showing, or raising of horses) ending with such taxable year, the activity was in fact carried on at a profit. For purposes of this presumption, the activity is treated as being carried on for a profit in a given taxable year if the gross income from the activity exceeds the deductions attributable to the activity which would be allowable if it were engaged in for profit.

The rules for determining whether an activity is a trade or business or engaged in for the production of income are the same as those used for determining whether an activity is engaged in for profit. As a result, except for the presumption discussed above, if deductions with respect to the activity are not allowable as a trade or business expense (sec. 162) or as expenses incurred for the production of income, etc. (sec. 212), then the activity will be treated as an activity not engaged in for profit under section 183.

The Regulations provide a list of relevant factors which should normally be taken into account in determining whether the activity is engaged in for profit. Among other factors, the presence of personal motives must be considered, especially where there are recreational or personal elements involved.[2] By way of illustration, the regulations provide that a taxpayer will be treated as holding a beach house primarily for personal purposes if, during a three-month season, the beach house is personally used by the taxpayer for one month and used for the production of rents for the remaining two months (Regs. § 1.183–1(d)(3)). However, except for this example, there are no

[2] Treas. Reg. § 1.183–2(b). These factors include: (1) The manner in which the taxpayer carries on the activity, (2) the expertise of the taxpayer or his advisers, (3) the time and effort expended by the taxpayer in carrying on the activity, (4) the expectation that assets used in the activity may appreciate in value, (5) the success of the taxpayer in carrying on other similar or dissimilar activities, (6) the taxpayer's history of income or losses with respect to the activity, (7) the amount of occasional profits, if any, which are earned, (8) the financial status of the taxpayer, and (9) the elements of personal pleasure or recreation.

definitive rules relating to how much personal use of vacation property will result in a finding that the rental of the vacation property is an activity not engaged in for profit.

Generally, no deduction is allowed for personal, living, and family expenses except as otherwise expressly provided under the tax laws (sec. 262). Deductions that are expressly allowable, even though they are attributable to personal use, include items of interest, certain taxes, and casualty losses. However, no deduction is allowed for such items as depreciation, maintenance, insurance, and utilities to the extent these items are attributable to personal use. As a result, under prior law, where property was used for both personal and business use, the total amount of maintenance, insurance, and utilities expenses and depreciation incurred during a taxable year had to be allocated on a reasonable and consistently applied basis.

Reasons for change

Where expenses attributable to a residence are treated as deductible business expenses, an opportunity exists to convert nondeductible personal, living and family expenses into deductible expenses. In the case of so-called "vacation homes" that are used both for personal purposes and for rental purposes, it would appear that frequently personal motives predominate and the rental activities are undertaken to minimize the expenses of ownership of the property rather than to make an economic profit.

In marketing vacation homes, it has become common practice to emphasize that certain tax benefits can be obtained by renting the property during part of the year, while reserving the remaining portion for personal use. In addition, certain arrangements have been devised whereby an individual owner of a condominium unit is entitled to exchange the time set aside for the personal use of his own unit (typically three to six weeks) for the use of a different unit under the same general management at another location.

Under many of these arrangements, it is extremely difficult under existing law to determine when an activity is engaged in for profit. The present regulations provide that in making this determination a number of factors shall be taken into account. These factors include the presence of "personal motives", especially where there are recreational or personal elements involved. However, except for the example mentioned above, no objective standards are set forth in the regulations. The Congress concluded that definitive rules should be provided to specify the extent to which personal use would result in the disallowance of certain deductions in excess of gross income. In a case where personal use is the controlling factor to be considered, this approach would obviate the need for subjective determinations to be made concerning the taxpayer's motive and the primary purpose for which the vacation home is held.

In addition, if there is any personal use of a vacation home, the portion of expenses allocable to rental activities should be limited to an amount determined on the basis of the ratio of time that the home is actually rented for a fair rental to the total time that the vacation home is used during the taxable year for all purposes (i.e., rental, business, and personal activities).

Explanation of provision

The Act adds a new provision (sec. 280A) which, in general, provides a limitation on the amount allowable to a taxpayer for the deductions attributable to the rental of a dwelling unit if the taxpayer personally uses the unit in excess of specified periods of time during a taxable year. This new limitation only applies if the taxpayer's use of the dwelling unit for personal purposes during his taxable year exceeds the greater of fourteen days or ten percent of the number of the days during the year for which the vacation home is rented. (Rules for determining personal use and rental days are discussed below.) The Act also provides that in the case where the taxpayer rents a dwelling unit used as a residence for less than 15 days, neither operating gain nor loss would be recognized for tax purposes.

The provisions of this section apply to an individual, a trust, estate, partnership, and an electing small business corporation. The provisions do not apply to corporate taxpayers (other than shareholders of subchapter S corporations). However, no inference should be drawn from this section in the case of a corporation, as to whether or not expenses incurred for the maintenance of a residence are connected with its trade or business for purposes of the tax laws.

If a taxpayer exceeds the personal use limitations for the dwelling unit for a taxable year, the deductions attributable to the rental activity are limited to the amount by which the gross income derived from the rental activity exceeds the deductions otherwise allowable without regard to such rental activities (e.g., interest and certain taxes). For this purpose, deductions attributable to the rental activities are those items which are of a type allowable only as expenses incurred in connection with a trade or business or the production of income (e.g., sec. 162 or 212).

If the personal use limitation applies, the allowable deductions would be determined after first determining the expenses of the dwelling unit which are allocable to the rental activities (in accordance with the new allocation rules). Generally, the amounts allowable as deductions would be determined in the same manner as provided in the regulations prescribed under section 183 of the Code.

The applicability of this new limitation on allowable deductions would be determined solely by reference to the taxpayer's personal use of the dwelling unit during his taxable year rather than, as under section 183, by reference to the profits or losses during any consecutive period of taxable years or on the basis of a facts and circumstances determination of the taxpayer's objectives. Generally, application of section 183 of the code would not be affected by these new provisions. Thus, if the rental of a dwelling unit is treated as an activity not engaged in for profit after consideration of the relevant objective standards prescribed by the regulations under section 183, deductions attributable to the rental activity would be limited under that provision (sec. 183) even though the new provisions did not apply because there was little or no personal use of the dwelling unit, i.e., the unit was not used for personal purposes for more than 14 days.

As indicated above, where the dwelling unit is rented for less than 15 days during the taxable year, neither operating gain nor operating loss would be recognized for Federal income tax purposes. Thus, where a dwelling unit is rented for less than 15 days, neither the new limitation under this new section nor the provisions of section 183 (pertaining to activities not engaged in for profit) are applicable. In this case, expenses which would be allowable if the taxpayer were in a trade or business or subject to the provisions of section 183 (e.g., maintenance, utilities, insurance and depreciation) will not be allowed as a deduction and any revenue received from the rental of a dwelling unit for less than 15 days will not be includible for tax purposes. However, a deduction for expenses otherwise allowable (e.g., interest, certain taxes and casualty losses) will be allowed as a deduction.

This new limitation, as indicated above, will not apply unless the taxpayer uses the dwelling unit for personal purposes during his taxable year for more than fourteen days or ten percent of the number of the days during such year for which the dwelling unit is rented, whichever is greater. For this purpose, a dwelling unit would not be treated as rented (at a fair rental) for any day for which it is treated as used for personal purposes. In the case of a dwelling unit owned by a partnership, trust, estate, or subchapter S corporation, the number of days of personal use by a taxpayer shall be determined by reference to the total number of days of personal use by the partners, beneficiaries, or stockholders, as the case may be. However, if two or more partners, beneficiaries, or stockholders personally use the dwelling unit during the same day, that day would constitute only one day of personal use. If a taxpayer owns a dwelling unit during only a portion of the taxable year, no reduction of the personal use specified under the provision would be required by reason that the dwelling unit was owned for less than a full year.

The taxpayer generally would be deemed to have used a dwelling unit for personal purposes for a day if, for any part of the day, the unit is used for personal purposes by (1) the taxpayer or any other person who owns an interest in the home; (2) their brothers and sisters, spouses, ancestors, or lineal descendants; (3) any individual who uses the unit under a reciprocal arrangement (whether or not a fair rental is charged); or (4) any other individual who uses the dwelling unit during a day unless for that day the unit is rented for a fair rental. With respect to use by a person other than the taxpayer who also owns an interest in the dwelling unit, the taxpayer would be deemed to have used the dwelling unit for personal purposes for a day if, for any part of the day the unit is used by a co-owner or a holder of any interest in the unit (other than a security interest or an interest under a lease for a fair rental) for personal purposes. For this purpose, any other ownership interest existing at the time the taxpayer has an interest in the unit shall be taken into account even if there are no immediate rights to possession and enjoyment under such other interest.

A taxpayer would not be considered to have personally used a dwelling unit with respect to a use by his employee, even if it is rented for less than a fair rental, if the value of such use is excludable from income by the employee under section 119 of the code (relating to meals and lodging furnished for the convenience of an employer). Further, if the taxpayer spends a normal work day cleaning, painting, repairing or otherwise maintaining the dwelling unit, such use shall not be treated as personal use.

For purposes of this new provision, the term "dwelling unit" includes a house, apartment, condominium, house trailer, boat, or similar property. The term would include any environs and outbuildings, such as a garage, which relate to the use of the dwelling unit for living accommodations. However, the term would not include that portion of a dwelling unit that is used exclusively as a hotel, motel, inn, or similar establishment.

In any case where there is any personal use of a dwelling unit during the taxpayer's taxable year (whether or not that personal use constitutes use as a residence), the expenses allocable to the rental of the vacation home will be limited to an amount which bears the same ratio to such expenses as the number of days the unit is actually rented out for the year bears to the total number of days the unit is actually used for all purposes during the year. However, the limitation upon allocable expenses would not apply to expenses such as interest or taxes which are allowable even if not attributable to the rental activity.

For purposes of this limitation, the personal use of a dwelling unit would be determined in accordance with the rules described above. However, for purposes of determining the relationship of rental days to total days of use, the number of rental days would include any day for which the dwelling unit is rented for a fair rental even if the taxpayer is deemed to have personally used the unit for that day. The period during which the unit is merely held out for rent would not be considered in determining the number of rental days for a taxable year.

Effective date

This provision applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision and the provision relating to business use of the home will increase revenues by $207 million in fiscal year 1977, $206 million in fiscal year 1978, and $305 million in fiscal year 1981.

3. Deductions for Attending Foreign Conventions (sec. 602 of the Act and sec. 274(h) of the Code)

Prior law

Generally, the deductibility of traveling expenses paid or incurred to attend a foreign convention, seminar, or similar meeting while away from home is governed by the ordinary and necessary standard under sections 162 and 212 of the code and, in certain cases, the special disallowance rules provided under section 274(c).

Generally, to be deductible, traveling expenses must be reasonable and necessary in the conduct of the taxpayer's business and directly attributable to the trade or business. If a trip is primarily related to the taxpayer's business and the special foreign travel allocation rules do not apply, the entire traveling expenses (including food and lodging) to and from a destination are deductible. If a trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even if the taxpayer engages in business activities while at the destination.[1] However, expenses incurred while at the destination which are allocable to the taxpayer's trade or business are deductible even if the transportation expenses are not deductible.

With respect to expenses incurred in attending a convention or other meeting, the test under section 162 is whether there is a sufficient relationship between the taxpayer's trade or business and his attendance so that he is benefiting or advancing the interests of his trade or business. Generally, deductibility depends upon the facts and circumstances of each particular case. (Reg. § 1.162–5(e)(1)). If the convention is for political, social, or other purposes unrelated to the taxpayer's business, the travel expenses are not deductible. The Internal Revenue Service has ruled that the test for allowance of deductions for convention expenses is met if the agenda of the convention or other meeting is so related to the taxpayer's position as to show that attendance was for business purposes. (Rev. Rul. 63–266, 1963–2 C.B. 88).

If an individual travels away from home primarily to obtain education for which the expenses are deductible as trade or business expenses, the expenses for travel, meals, and lodging incurred while away from home are deductible. However, the portion of the travel expenses attributable to personal activities, such as sightseeing, is treated as a nondeductible personal or living expense. If the travel away from home is primarily personal, only the meals and lodging incurred during the time spent in participating in educational pursuits are deductible. Further, in the case of foreign travel to obtain education, deductions are subject to special allocation rules.

Under section 274(c) of the code, expenses of travel outside the United States are deductible only to the extent allocable to the taxpayer's trade or business or income-producing activities if such travel is for more than one week or the time of travel outside the United States which is not attributable to the pursuit of the taxpayer's trade or business is 25 percent or more of the total time on such travel. In the case of foreign travel to which section 274(c) applies, this allocation requirement overrides the general rule that the entire expenses of travel are deductible if the primary purpose of the trip was related to a trade or business.

General reasons for change

Serious administrative problems have arisen because of the recent proliferation of conventions, educational seminars, and cruises which were ostensibly held for business or educational purposes, but which were held at locations outside the United States primarily because of the recreational and sightseeing opportunities. In Technical Information Release 1275 (February 14, 1974), the Internal Revenue Service announced that it intended to scrutinize deductions for business trips, conventions, and cruises which appear to be vacations in disguise. The Service noted that a number of professional, business and trade organizations have been sponsoring cruises, trips and conventions during which only a small portion of time is devoted to business activity and that the practice seemed to be growing. In cases where there were indi-

[1] See *Patterson* v. *Thomas*, 289 F. 2d 108 (5th Cir., 1961); *Espandiar Kadivar*, T.C. Memo 1973–95; Rev. Rul. 74–292, 1974–1 C.B. 43.

cations of abuse, the Service intended to request lists of the names and addresses of the participants on cruises and other trips. However, under prior law, allowance of deductions claimed by participants continued to depend upon the facts and circumstances, including the relationship of the meeting to a particular taxpayer's trade or business.

As indicated above, the basic test that has been applied by the Internal Revenue Service was whether the convention or other meeting was primarily related to the taxpayer's business or whether it was primarily personal in nature. Thus, in administering this test, the Internal Revenue Service was required to make a subjective determination as to the motives and intentions of the taxpayer after taking into account all the facts and circumstances in a particular case. One of the important factors considered by the Service in making this subjective determination was the amount of time spent on business activities as compared to the amount of time spent on personal activities. There were no specific guidelines or formulae in the statute or regulations that specified when this factor would weigh in the favor of or against the taxpayer. The taxpayer was not required to keep detailed records relating to the amount of time spent on each of these activiites. Upon audit, the taxpayer frequently attempted to substantiate the business nature of his trip by providing the Service with the agenda from the meeting or a certificate of attendance which was furnished by the organization sponsoring the meeting.[2]

The administrative problems created by the lack of specific guidelines were substantial. The process of trying to ascertain all the facts and circumstances was extremely time consuming both for the taxpayer and the Service. Further, additional importance was placed on the subjective judgment of the IRS because of the basically "all or nothing" approach under prior law. If the primary purpose was determined to be pleasure, no amount of the travel expense could be deducted. Since reasonable and competent auditors differed in evaluating all the facts and circumstances, the deduction of one taxpayer could be totally disallowed while another taxpayer (perhaps with slightly different facts) could obtain a complete deduction for travel expenses. This disparity of treatment resulted in complaints that the Service did not treat taxpayers equally.

The Congress was concerned that the lack of specific detailed requirements has resulted in a proliferation of foreign conventions, seminars, cruises, etc. which, in effect, amounted to Government-subsidized vacations and served little, if any, business purpose. It was indicated that the promotional material often highlight the deductibility of the expenses incurred in attending a foreign convention or seminar and, in some cases, describe the meeting in such terms as a "tax-paid vacation" in a "glorious" location. In addition, it was pointed out that there were organizations that advertised that they could find a convention for the taxpayer to attend in any part of the world at any given time of the year. This type of promotion had an adverse impact on public confidence in the fairness of the tax laws.

Explanation of provision

The act limits the deductions allowable for the expenses of indi-

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[2] A few organizations maintained attendance records and required participants to "sign in" at each session of the convention or seminar.

viduals attending foreign conventions. The term "foreign convention" means any convention, seminar or similar meeting held outside the United States, its possessions, and the Trust Territory of the Pacific.

Generally, under the act, no deduction will be allowed for expenses paid or incurred by an individual in attending more than two foreign conventions in any taxable year. In addition, with respect to the two conventions for which a deduction is allowable, the act limits the amount of expenses that can be deducted for transportation and subsistence. If an individual attends more than two foreign conventions in a year, he must select which two of the foreign conventions are to be taken into account for purposes of determining the allowable deductions.

The provisions apply to any person, whether or not such person is the individual attending the foreign convention. For example, if an employee is reimbursed for attending a foreign convention on behalf of his employer corporation (or if the corporation directly pays the expenses), the corporation will be allowed a deduction for the expenses of attending the foreign convention only to the extent that the employee is (or would be) allowed a deduction. Thus, the corporation would be allowed a deduction for the reimbursement (subject to the transportation and subsistence limitations) only if the employee selects the convention as one of the two conventions to be taken into account for the taxable year. In applying these provisions to a corporation, it is intended that the two convention rule be applied on an employee-by-employee basis.

With respect to subsistence expenses incurred to attend a foreign convention, no deduction will be allowed unless: (1) a full day or half-day of business activities are scheduled on each day during the convention and (2) the individual attending the convention attends at least two-thirds of the hours of the daily scheduled business activities or, in the aggregate, attends at least two-thirds of the total hours of scheduled business activities at the convention. A full day of scheduled business activities means a day during which at least 6 hours of business activities are scheduled and a half-day means a day during which at least 3 hours of business activities are scheduled. Thus, if 6 hours of business activities are scheduled for a day, the individual must attend at least 4 hours for it to be counted as a full day. However, if the individual attends only 2 of the 6 hours scheduled, the day will not count either as a full day related to business activities or as a half-day related to business activities. If a convention has scheduled more than 6 hours of business activities (or more than 3 hours and less than 6 hours in the case of half-days) on a day, then the actual hours of scheduled business activities will be taken into account in computing whether or not the individual has attended at least two-thirds of the hours of the daily scheduled business activities. Similarly, in determining whether the two-thirds aggregate test is met, all scheduled hours of business activities will be taken into account.

In no event will time spent at parties, receptions, or similar social functions be taken into account for purposes of determining whether the required 3 or 6 hours of business activities were scheduled. Further, where there is a banquet at which there is a speaker or lecturer, only the time attributable to the speech or lecture (if business related) will be taken into account.

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In the case where subsistence expenses are allowed under the Act, the amount allowable as a deduction while at the convention or traveling to or from the convention is not to exceed the dollar per diem rate for the site of the convention which has been established for United States civil servants under section 5702(a) of title 5 of the United States Code and which is in effect for the calendar month in which the convention begins. For purposes of this provision, "subsistence expenses" means lodging, meals, and other necessary expenses for the personal sustenance and comfort of the traveler, including tips and taxi and similar transportation expenses.

With respect to transportation expenses outside the United States, the amount allowable as a deduction may not exceed the lowest coach or economy rate charged by any commercial airline for such transportation during the calendar month the convention is held. However, where the taxpayer travels coach or economy class on a regularly scheduled flight of a common carrier, the cost of that economy or coach fare is to be allowed as a deduction (subject to the special foreign travel allocation rules if applicable). If there is no coach or economy rate, the deduction allowable would be limited to the lowest first class rate charged by any commercial airline for such transportation. Transportation expenses for travel within the United States are deductible to the extent the cost is reasonable.

A deduction for the full expenses of transportation (subject to the coach or economy rate limitation) to and from the site of a foreign convention will be allowable only if one-half or more of the total days of the trip are devoted to business-related activities. In determining whether a day is devoted to business-related activities, the same rules for counting full days and half-days for purposes of subsistence expenses are to be applied.

If less than one half of the total days of the trip are devoted to business-related activities, then only a proportionate amount of the transportation expenses will be allowable as a deduction. The amount allowable is to be determined by multiplying the transportation expenses paid or incurred (after the application of the coach or economy rate rule) by a fraction, the numerator of which is the total days of the trip devoted to business-related activities and the denominator of which is total days of the trip. For purposes of this provision, the travel days to and from the site of the convention shall not be taken into account in determining the total days of the trip or of business related activities.

In any case where the transportation and subsistence expenses are either not separately stated or under the facts and circumstances there is reason to believe that the allocation of expenses between transportation and subsistence expenses is not properly reflected, all amounts paid for such expenses shall be treated as having been paid solely for subsistence expenses subject to the subsistence expense per diem limitation.

The Act provides that no deduction is to be allowed unless the taxpayer complies with certain reporting requirements in addition to the substantiation requirements of present law. Under these reporting requirements, the taxpayer must furnish information indicating the total days of the trip (exclusive of the transportation days to and from the convention), the number of hours of each day that he devoted to business activities (and a brochure describing the convention, if available), and furnish any other information required by regulations. In addition, the taxpayer must attach a statement signed by an appropriate officer of the sponsoring organization to his income tax return which must include a schedule of the business activities of each convention day, the number of hours of business-related activities that the taxpayer attended each day and any other information required by regulations.

Effective date

This provision shall apply to conventions beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will result in an increase in fiscal year receipts of less than $5 million annually.

4. Qualified Stock Options (sec. 603 of the Act and secs. 422 and 424 of the Code)

Prior law

An employee stock option is a right, which is limited in time, granted by a corporate employer to one or more employees to purchase a stated amount of stock in the corporation at a stated price. An option is a relatively low risk means of acquiring an equity interest in a corporation, since the option need not be exercised unless the value of the stock increases during the option period. If the value of the stock drops below the price at which the stock may be purchased (i.e., below the option price), the employee can allow the option to lapse (although ordinarily the employee would lose the amount which he may have originally paid for the option, if any).

Under prior law, employee stock options fell broadly into two categories: "qualified" and nonqualified options. The former category was governed by statutory rules which set forth conditions which the option must meet in order to receive the favorable tax treatment accorded "qualified" stock options under prior law. Employee options which do not satisfy these requirements (often called "non-qualified" or "nonstatutory" options) are governed by rules set forth in the income tax regulations (Regs. § 1.421–6) and by certain statutory rules which apply generally to property transferred to employees in connection with their performance of services (sec. 83).

Under prior law, no income was recognized on the grant to a corporate employee, or on his exercise of, a "qualified" option to receive stock in the employer corporation (sec. 421). The stock acquired by the exercise of the option is a capital asset in the hands of the employee and the income realized from the eventual sale of the stock is generally treated as long-term capital gain or loss.[1]

No deduction was available to the employer, as a business expense (under sec. 162) with respect to either the granting of a qualified stock option or the transfer of stock to the employee when he exercised a qualified option.

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[1] Generally similar tax treatment was also available in the case of "restricted" stock options, which were the predecessors to qualified options, but restricted stock options are no longer being granted, and most restricted options which were granted in the past have now been exercised or have lapsed.

A qualified option (meeting the requirements in sec. 422) must be granted pursuant to a plan approved by the shareholders of the corporation. The option must, by its terms, be exercised within 5 years from the date it is granted and the purchase price of the shares (option price) may not be less than the fair market value of the company's stock on the date when the option is granted to the employee. In addition, any stock acquired under a qualified option may not be disposed of within 3 years after it is transferred to the employee. The option must also be exercised while the option holder is an employee of the corporation, or within three months after the termination of his employment.

By contrast, nonqualified stock options were (and remain) generally subject ot the rules of section 83. Generally, under section 83, the value of a nonqualified stock option constitutes ordinary income to the employee if the option itself had a readily ascertainable fair market value at the time it was granted to the employee. If the option did not have a readily ascertainable value when granted, it would not constitute ordinary income at the time it was granted; when the option is exercised, however, the spread between the option price and the value of the stock at that time constitutes ordinary income to the employee.

As can be seen from the above description, qualified options had the advantage that an executive was not required to pay any ordinary income tax on the value of the option as such when the company grants it to him, or on any "bargain element" which may exist if and when he decided to exercise the option and purchase stock in the company. (The bargain element is the excess of the fair market value of a share of stock over its purchase price.) The employee was only required to pay tax when he sold the shares purchased under the option. Further, if he held the shares for at least 3 years (as required for the option to remain qualified) he was entitled to pay tax at capital gain rates on the full amount of his gain (if any) over the price which he originally paid to buy the shares.

Although an employee did not have to pay tax under the qualified stock option rules at the time he exercised the option and received stock worth more than he paid for it, the bargain element was treated as an item of tax preference. (This rule remains in effect for qualified options granted and exercised under certain transition rules described below.) This means that the excess of the fair market value of the share at the time of exercise over the purchase price paid by the employee was subject to the minimum tax.

Reasons for change

The principal reason for the prior tax treatment of qualified stock options was said to be that such treatment allowed corporate employers to provide "incentives" to key employees by enabling these employees to obtain an equity interest in the corporation. However, it seems doubtful whether a qualified stock option gives key employees more incentive than does any other form of compensation, especially since the value of compensation in the form of a qualified option is subject to the uncertainties of the stock market. Moreover, even to the extent a qualified option is an incentive, it still represents compensation and the Congress believes that as such it should be subject to tax in much the same manner as other compensation. Moreover, to the extent that there was an incentive effect resulting from stock options, it could be argued that prior law discriminated in favor of corporations (which were the only kind of employers who could grant qualified options) as opposed to all other forms of business organization.

Explanation of provisions

Under the Act, prior law will not apply to qualified stock options granted after May 20, 1976, except in the case of an option granted under a written plan adopted and approved on or before that date, or under a plan adopted by a board of directors on or before May 20, 1976 (even if the plan is approved by the shareholders after that date).

Thus, generally, stock options granted after May 20, 1976, whether or not otherwise qualified (under the requirements of section 422) will be subject to the rules which apply in the case of most nonqualified options granted after June 30, 1969 (sec. 83 of the code). Under these rules, if an employee receives an option which has a readily ascertainable fair market value at the time it is granted, this value (less the price paid for the option, if any) constitutes ordinary income to the employee at that time.[2]

On the other hand, if the option does not have a readily ascertainable fair market value at the time it is granted, the value of the option does not constitute income to the employee at that time, but would be taxable to the employee when the option is exercised. The ordinary income recognized at that time is the spread between the option price and the value of the stock (unless the stock is nontransferable and subject to a substantial risk of forfeiture).

Any option which is subject to the provisions outlined above (sec. 83) is not treated as a tax preference for purposes of the minimum tax.

To illustrate these rules, consider the case of a qualified option granted to a corporate executive to buy 100 shares at $10 per share. The employee exercises the option in full when the shares are selling at $15 per share in the open market. Under the act, this transaction would be treated (under sec. 83) as follows:

(a) At the time that the company grants the option to the executive, if the option as such has a readily ascertainable fair market value, the value of the option (less any amount which he may have been paid for it) is taxable to the executive as ordinary income.

(b) If the option itself does not have a readily ascertainable market value, the executive will be subject to tax when he exercises the option and acquires the shares under option to him. In this example, the employee will be taxable on the $5 per share bargain element (or a total of $500) at the time he exercises his option. This income will be treated as compensation taxable at ordinary income rates.[3]

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[2] However, if the option is nontransferable and is also subject to a substantial risk of forfeiture, recognition of income would be postponed until one or both of these encumbrances is removed.

[3] As indicated above, recognition of income could be postponed if the stock is not transferable and if it is subject to a substantial risk of forfeiture. In this case, the tax is imposed (at ordinary income rates) at the time when either of these two restrictions is removed and the tax base is the excess of the fair market value of the shares at the time when either of these two restrictions is removed over the amount which the employee originally paid for the property. However, under section 83, an employee who receives stock (or other property) in his employer corporation burdened by restrictions which would free him from paying a tax at that time may, nevertheless, elect to pay tax on the bargain element existing at that time. If the employee makes this election and pays tax when he exercises the option, any later increase in value of the shares will generally be taxable to him as capital gain (rather than compensation income) when he disposes of the shares.

Income recognized by the employee under these rules would generally constitute earned income for purposes of the maximum tax on earned income (sec. 1348).

(c) After the executive pays tax at ordinary income rates on the compensation portion of the transaction, he would be entitled to add the amount of ordinary income recognized to his basis in the shares. Any further gain (realized when the employee sells the shares) would generally be taxable as a capital gain.

(d) The employer corporation is entitled to a deduction (under sec. 83) in an amount equal to the ordinary income realized by an employee under the above rules. The employer's deduction accrues at the time that the employee is considered to have realized compensation income.

The Congress intends that in applying these rules for the future, the Service will make every reasonable effort to determine a fair market value for an option (i.e., in cases where similar property would be valued for estate tax purposes) where the employee irrevocably elects (by reporting the option as income on his tax return or in some other manner to be specified in regulations) to have the option valued at the time it is granted (particularly in the case of an option granted for a new business venture). The Congress intends that the Service will promulgate regulations and rulings setting forth as specifically as possible the criteria which will be weighed in valuing an option which the employee elects to value at the time it is granted.

Of course, merely because the option is difficult to value does not mean that the option has no value. The Congress intends that under these rules, the value of an option would be determined under all the facts and circumstances of a particular case. Among other factors that would be taken into account would be the value of the stock underlying the option (to the extent that this could be ascerained), the length of the option period (the longer the period, the greater the chance the underlying stock might increase in value), the earnings potential of the corporation, and the success (or lack of success) of similar ventures. Corporate assets, including patents, trade secrets and knowhow would also have to be taken into account.

The Congress anticipates that under the Service's rules, certain options, such as those traded publicly, would be treated as having a readily ascertainable fair market value, regardless of whether the employee makes an election. However, the regulations could provide that in certain other cases the option would ordinarily not be valued at the time it is granted unless the employee so elects.

The rules outlined above are not to apply to employee "stock purchase plans" (described in sec. 423 of the Code) under which the rank and file employees of a corporation (as well as the executives) are afforded an opportunity to purchase corporate stock on a nondiscriminatory basis. The prior Federal tax treatment of this type of plan is not affected by this provision of the Act.

The Act also provides certain transition rules so as not to disturb arrangements which were entered into in reliance on prior law. Under the transition rules, prior law will continue to govern qualified stock options granted pursuant to a written qualified stock option plan which was adopted by the board of directors of the corporation before May 21,

1976. For purposes of this rule, it is immaterial whether the shareholders approve the plan before, on, or after the date, although in order to be a qualified plan the shareholders must approve the plan within 12 months before or after its adoption by the board (sec. 422(b)(1)). In order to retain its qualification the option must be exercised by the employee before May 21, 1981 (i.e., within five years of the May 20, 1976 cutoff date). However, this requirement does not have to be spelled out under the terms of the option; it is sufficient if the option is actually exercised on or before May 20, 1981.

In general, a plan is to be treated as having been "adopted" by the board of directors of the corporation by May 20, 1976, only if all of the action required for adoption has been completed by that date. For example, if the plan had been adopted by the directors of a corporation under procedures which were valid under State law, the plan would generally be treated as having been "adopted" within the meaning of the statute. For purposes of these rules, any amendment of an existing plan to increase the number of shares which may be granted under the plan is to be treated as a new plan. Thus options granted as a result of a plan amendment adopted after May 20, 1976, would not be qualified options. It is not necessary, however, in the case of a plan adopted by May 20, 1976, for options to have been granted under the plan by that date or for the directors or shareholders to have authorized the specific grant of options under the plan to specific individuals.

If qualified options are granted under the transition rule, but the options are not exercised until after May 20, 1981, the Congress intends that the option is to be treated as an option which did not have a readily ascertainable fair market value at the time it was granted (within the meaning of sec. 83(e)(3)). Thus, the value of the option in this case would not constitute income to the employee when granted (or at a time the transition rule expires), but if the option subsequently is exercised, and if the fair market value of the stock exceeds the option price, this excess will constitute ordinary income to the employee at the time of exercise.

The Act also requires that all outstanding restricted stock options (sec. 424) must be exercised on or before May 20, 1981, in order to receive the Federal tax treatment previously accorded these options.

As under prior law, in the event of a corporate merger, consolidation or other reorganization, the employer corporation may substitute a new option for an old option, as long as the new option and the old option are substantially equivalent (sec. 425). Thus the surviving corporations in a corporate merger could substitute options on its stock for options on the stock of the nonsurviving corporation, so long as the options were of equivalent value and the new option did not provide for any additional benefits for the employee which he did not have under the old option. These substitutions can occur after May 20, 1976, on the same basis as before that date. (Of course, "old options" could not be granted after May 20, 1976, by the acquired corporation, except as provided under the transition rules. However, if a corporation adopted an option plan in 1974 and is reorganized in 1977 into a holding company with one or more operating subsidiaries, the holding company may adopt the 1974 option plan and continue to grant qualified stock options to the extent permissible had the reorganization not occurred.)

Effective date

The amendments with respect to qualified stock options apply to taxable years ending after May 20, 1976.

Revenue effect

This program will increase budget receipts by $7 million in fiscal year 1977, $20 million in fiscal year 1978, and $5 million in fiscal year 1981.

5. Treatment of Losses From Certain Nonbusiness Guaranties (sec. 605 of the Act and sec. 166 of the Code)

Prior laws

Under prior law (which remains in effect), in the case of a noncorporate taxpayer, "business" bad debts are deductible as ordinary losses for the year in which the debt becomes worthless or partially worthless. On the other hand, "nonbusiness" bad debts are treated as short-term capital losses, which means that the losses are offset first against the taxpayer's capital gains (if any), and may then be deducted against ordinary income to the extent of $1,000 per year.

On the other hand, where the noncorporate taxpayer's loss results from a situation where he guaranteed the debt of a noncorporate person, and was required to make good on that guaranty because the borrower defaulted, section 166(f) of the code provided that the guarantor could treat the payment under the guaranty as a business bad debt (even though the guaranty did not arise in connection with the guarantor's trade or business) if the proceeds of the loan were used by the borrower in his trade or business, and the debt was worthless when payment was made by the guarantor (i.e., the borrower was insolvent). The deduction is allowed for the year in which the payment is made.

However, the guarantor of a corporate obligation which becomes worthless must treat the guaranty payment as a nonbusiness bad debt (Reg. § 1.166–8(b)). Also, if the loan was not used in the borrower's trade or business, the provisions of section 166(f) did not apply. However, the guarantor's payment was still deductible as a nonbusiness bad debt (short-term capital loss) if the debt was worthless when paid and the guarantor had a right of reimbursement (subrogation) against the borrower.[1]

Where the guarantor had no right of subrogation, there was some uncertainty as to whether, and under what circumstances, the guarantor was entitled to deduct his guaranty payment. For some time it was believed that the payment could not be deducted as a bad debt on the theory that unless there is a right of recovery against the borrower, there is no "debt" which might become worthless in the hands of the guarantor. However, if the guaranty transaction was entered into in connection with the taxpayer's trade or business, or the agreement was part of a transaction entered into for profit on the part of the taxpayer, then the payment was claimed to be deductible as a loss under

[1] If the debt is not worthless, no deduction is generally allowed (on the theory that payment by the guarantor was voluntary).

section 165.[2] More recently, courts have held that there was a bad debt on the grounds that there was an implied promise on the part of the borrower to reimburse the guarantor for his payments.[3]

General reasons for change

As discussed above, where a taxpayer makes a loan which is not connected with his trade or business, and the debt becomes worthless, he is generally required to treat the loss as a short-term capital loss. On the other hand, where a third party made the loan, which was guaranteed by the taxpayer, and the proceeds of the loan were used by the borrower in his trade or business, any loss which results could generally be deducted by the taxpayer against ordinary income. The Congress concluded that this distinction made little sense and gave a tax advantage to guaranteeing loans over making them directly.

Explanation of provisions

To provide for more consistent treatment in the area of bad debts and guaranties, the Act repeals section 166(f) of the Internal Revenue Code, effective for taxable years beginning after December 31, 1975. Thereafter, when a taxpayer has a loss arising from the guaranty of a loan, he is to receive the same treatment as where he has a loss from a loan which he makes directly. Thus, if the guaranty agreement arose out of the guarantor's trade or business, the guarantor would still be permitted to deduct the loss resulting from the transaction against ordinary income. If the guaranty agreement was a transaction entered into for profit by the guarantor (but not as part of his trade or business), he would be able to deduct the resulting loss as a nonbusiness debt.

Also, in the case of a guaranty agreement which is not entered into as part of the guarantor's trade or business, or as a transaction for profit, no deduction is to be available in the event of a payment under the guarantee.

Generally, in the case of a direct loan, the transaction is entered into for profit by the lender, who hopes to realize interest on the loan. However, this may not be true in the case of loans made between friends or family members, and in these cases the Internal Revenue Service will generally treat any loss resulting from such a "loan" as a gift, with respect to which no bad debt deduction is available. (Reg. § 1.166–1(c))

In the case of a guaranty agreement, however, it is not always easy to tell whether the transaction has been entered into for profit on the part of the guarantor. It is not uncommon for guaranty agreements to provide for no direct consideration to be paid to the guarantor. Often this may be because the guarantor is receiving indirect consideration in the form of improved business relationships. On the other hand, many other guaranties are given without consideration as a matter of accommodation to friends and relatives.

The Congress believes that a bad debt deduction should be avail-

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[2] The legal theory led to attempts on the part of some taxpayers to take themselves out of the general rules relating to guaranties of debts by taking steps to insure that they would have no right of subrogation against the borrower if he defaulted. (This was particularly true in the case of guaranties by taxpayers of corporate obligations where the taxpayer was a shareholder in a closely held corporation.) The taxpayer would then attempt to claim an ordinary loss deduction under section 165, instead of receiving nonbusiness bad debt treatment under section 166.

[3] See e.g., *Bert W. Martin*, 52 T.C. 140 (reviewed by the Court), aff'd per curiam, 424 F.2d 1368 (9th Cir.) cert. denied, 400 U.S. 902 (1970).

able in the case of a guaranty related to the taxpayer's trade or business, or a guaranty transaction entered into for profit. However, no deduction should be available for a "gift" type of situation. Thus, the Congress intends that for years beginning in 1976 (in the case of guaranties made after 1975) and thereafter, the burden of substantiation is to be on the guarantor, and that no deduction is to be available unless the guaranty is entered as part of the guarantor's trade or business, or unless the transaction has been entered into for profit, as evidenced by the fact that the guarantor can demonstrate that he has received reasonable consideration for giving the guaranty. For this purpose, consideration could include indirect consideration; thus, where the taxpayer can substantiate that a guaranty was given in accordance with normal business practice, or for *bona-fide* business purposes, the taxpayer would be entitled to his deduction even if he received no direct monetary consideration for giving the guaranty. On the other hand, a father guaranteeing a loan for his son would ordinarily not be entitled to a deduction even if he received nominal consideration for giving the guaranty.

The Congress also wishes to make it clear that in the case of a guarantor of a corporation obligation, any payment under the guaranty agreement must be deducted (if at all) as a nonbusiness bad debt, regardless of whether there is any right of subrogation, unless the guaranty was made pursuant to the taxpayer's trade or business. Of course, if the payment under the guaranty by a corporate shareholder constitutes a contribution to capital, under the facts and circumstances of the particular case, the payment would not be deductible but would increase the stockholder's basis in his shares in the corporation. This rule is consistent with Congress' understanding of present law.

The Congress further wishes to resolve for the future the appropriate timing of the deduction for a payment under a guaranty agreement. If the guaranty agreement (including for this purpose a guaranty, indemnity or endorsement) requires payment by the guarantor upon default by the maker of the note (i.e., the borrower), and the guarantor has a right of subrogation or other right against the maker, no deduction will be allowed to the guarantor until the year in which the right over against the maker becomes worthless (or partially worthless, where the guaranty occurs in connection with the guarantor's trade or business). If the guarantor has no right over against the maker of the obligation, the payment under the guaranty is deductible as a bad debt for the year in which the payment is made. Of course, if the payment is voluntary in the sense that there is no legal obligation to make the payment,[4] or a guaranty agreement is entered after the debt has become worthless, no deduction is to be available.

Effective date

The provisions of this amendment are to be effective for taxable years beginning after December 31, 1975 in connection the guaranties made after that date.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of $1 million in fiscal year 1977 and of 5 million annually thereafter.

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[4] It is not intended that legal action must have been brought against the guarantor in order to entitle him to take an otherwise available deduction; but there must be an enforceable legal obligation on his part to make the payment.

F. ACCUMULATION TRUSTS

(Sec. 701 of the Act and secs. 644 and 665–669 of the Code)

Prior law

A trust is generally treated as a separate entity which is taxed in the same manner as an individual. However, there is one important difference: the trust is allowed a special deduction for any distributions of income to beneficiaries. The beneficiaries then include these distributions in their income for tax purposes. Thus, in the case of income distributed currently, the trust is treated as a conduit through which income passes to the beneficiaries, and the income so distributed retains the same character in the hands of the beneficiaries as it possessed in the hands of the trust.

If a grantor creates a trust under which the trustee is either required, or is given discretion, to accumulate the income for the benefit of designated beneficiaries, however, then, to the extent the income is accumulated, it is taxed at individual rates to the trust. An important factor in the trustee's (or grantor's) decision to accumulate the income may be the fact that the beneficiaries are in higher tax brackets than the trust.

Beneficiaries are taxed on distributions of previously accumulated income from trusts in substantially the same manner as if the income had been distributed to the beneficiaries currently as earned, instead of being accumulated in the trust. This is accomplished through the so-called "throwback rule," under which distributions of accumulated income to beneficiaries are thrown back to the year in which the income would have been taxed to the beneficiary if it had been distributed currently. The Tax Reform Act of 1969 revised the prior throwback rule to provide an unlimited throwback rule with respect to accumulation distributions.

Under prior law, the tax on accumulation distributions was computed in either of two ways. One method was the "exact" method, and the other was a "shortcut" method which did not require the more extensive computations required by the exact method. Under the exact method of computation, the tax on an accumulation distribution could not exceed the aggregate of the taxes that would have been payable if the income had actually been distributed in the prior years when earned. This method required complete trust and beneficiary records for all past years so that the distributable net income of the trust and the taxes of the beneficiary could be determined for each year. The beneficiary's own tax then was recomputed for these years, including in his income the appropriate amount of trust income for each of the years (including his share of any tax paid by the trust). Against the additional tax computed in this manner, the beneficiary was allowed a credit for his share of the taxes paid by the trust. Any remaining tax then was due and payable as a part of the tax for the current year in which the distribution was received.

The so-called shortcut method in effect determined the tax attributable to the accumulation distribution by averaging the distribution over a number of years during which the income was earned by the trust. This was accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income of each of the 3 immediately prior years. The fraction of the income included in each of these years was based upon the number of years in which the income was accumulated by the trust.

Prior law also provided an unlimited throwback rule for capital gains allocated to the corpus of an accumulation trust. This provision normally did not apply to "simple trusts" (any trust which is required by the terms of its governing instrument to distribute all of its income currently) or any other trusts, which in fact distribute all their income currently, until the first year they accumulated income. For purposes of this provision, a capital gains distribution was deemed to have been made only when the distribution was greater than all of the accumulated ordinary income. If the trust had no accumulated ordinary income or capital gains, or if the distribution was greater than the ordinary income or capital gain accumulations, then to this extent it was considered a distribution of corpus and no additional tax was imposed.

Reasons for change

The progressive tax rate structure for individuals is avoided if a grantor creates a trust to accumulate income taxed at low rates, and the income in turn is distributed at a future date with little or no additional tax being paid by the beneficiary, even when he is in a high tax bracket. This result occurs because the trust itself is taxed on the accumulated income rather than the grantor or the beneficiary.

The throwback rule (as amended by the Tax Reform Act of 1969) modifies this result by taxing beneficiaries on distributions they receive from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiaries currently as it was earned. The 1969 Act made a number of significant revisions in the treatment of accumulation trusts. In applying the throwback rule to beneficiaries with respect to the accumulation distributions they receive, the 1969 Act provided two alternative methods, as indicated above, the exact method and the shortcut method. A number of administrative problems have resulted in the application of these alternative methods for both the Internal Revenue Service and the beneficiaries.

For example, taxpayers are under an obligation, as a practical matter, to compute the throwback under the rule which results in the least tax; thus, the shortcut method, which was intended to simplify calculations and eliminate recordkeeping problems involved with the exact method has not achieved this result because taxpayers must compute the tax under both methods. As a result, the Congress believed it was more desirable to have one simplified method rather than having two alternative methods in applying the throwback rule. In the case of multiple trusts, however, the Congress was concerned about the potential tax avoidance use of such trusts. As a result, the Act provides a special rule in the case of accumulation distributions received by any beneficiary from three or more trusts.

In addition, a number of questions were raised as to whether the capital gains throwback rule, which was enacted in the 1969 Act, presented more complexity in its application than was warranted by the concerns raised in 1969 with respect to capital gains. The Congress believed it was appropriate to repeal the capital gains throwback rule and provided instead a rule to deal more directly with the transferring of appreciated assets by grantors into trusts.

The Congress also reviewed other aspects of the tax treatment of accumulation trusts and provided modifications to make the rules easier to apply and be administered. For example, the Act provides an exemption for the income accumulated in a trust during the minority of a beneficiary, as was provided in the law under the throwback rule before 1969.

Explanation of provisions

The Act substitutes for the two alternative methods used in computing the throwback rule for accumulation distributions a single method, which is a revision of the present "shortcut" method. The new shortcut method provided under the Act determines (in effect) the tax attributable to the distribution by averaging the distribution over a number of years equal to the number of years over which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income for each of the 5 preceding years (rather than the 3 preceding years under present law).[1] The fraction of the income included in each of these years is based upon the number of years in which the income was accumulated by the trust (as determined under prior law). This average amount is added to the beneficiary's taxable income for these years (rather than requiring the recomputation of his tax returns as under prior law).[2]

Of these 5 preceding years, the year with the highest taxable income and the year with the lowest would not be considered; in effect, then, the computation of the additional tax on the accumulation distribution under this shortcut method is based, as under prior law, on a 3-year average basis.

In general, except as indicated below, the rules under the shortcut method continue to apply. Thus, if the accumulated income is attributable to 10 different years (although the trust may have been in existence longer than 10 years), then one-tenth of the amount distributed would be added to the beneficiary's taxable income in each of the 3 years. The additional tax is then computed with respect to these 3 years and the average yearly additional tax for the 3-year period is determined. This amount is then multiplied by the number of years to which the trust income relates (10 in this example). The tax so computed may be offset by a credit for any taxes previously paid by the trust with respect to this income and any remaining tax liability is then due and payable in the same year as the tax on the beneficiary's other income in the year of the distribution. Under the Act, unlike

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[1] The accumulated income which is to be included in the beneficiary's income for any year under the shortcut method is the income of the trust which would have been included in the beneficiary's income if the trust had made the distributions currently rather than accumulating the income. As a result, the character of any tax-exempt interest would be carried with the accumulated income and, thus, would not be subject to tax to the beneficiary.

[2] For purposes of adding the accumulated income to the taxable income of a beneficiary for a year, the beneficiary's taxable income may not be less than zero. Thus, if in any year to which the shortcut method applies a beneficiary has a net operating loss, the beneficiary's taxable income for that particular year will be treated as being zero.

under prior law, no refunds or credits are to be made to any beneficiary or a trust as a result of any accumulation distributions.

The Act provides a special rule to deal with multiple trusts where a beneficiary receives an accumulation distribution from more than two trusts with respect to the same year. Under this rule, in the case of a distribution from the third trust (and any additional trusts), the beneficiary is to recompute his tax under the revised shortcut method in the same manner as indicated above except that no credit is to be given for any taxes previously paid by the trust with respect to this income. The Act provides a *de minimis* rule under which this special multiple trust rule is not to apply. Under this *de minimis* rule, the special multiple trust rule is not to apply where an accumulation distribution from a trust (including all prior accumulation distributions from the trust to the beneficiary for that same year) is less than $1,000.

The Act provides that the throwback rule is not to apply to any distributions of income accumulated for a beneficiary while he was a minor; that is, before the birth of such beneficiary or before the beneficiary is 21 years of age. This exception for minors, however, is not to apply in the case of distributions covered under the multiple trust rule.

The Act also modifies the rules for determining when an accumulation distribution is made. Under prior law, if a trust had deductions taken into account in determining distributable net income, for example, fees which are chargeable to corpus, the trust accounting income (as defined under section 643(b)) exceeded the distributable net income of the trust. In this case, a distribution of the current year's trust income to a beneficiary, which otherwise is technically the accounting income of the trust for the year, was treated as constituting an accumulation distribution of the trust. To deal with this situation, the Act provides a rule that a distribution made or required to be made by a trust to a beneficiary in a year which does not exceed the income of the trust for the year is not to be treated as an accumulation distribution for that year.

The Act also repeals the capital gain throwback rule under prior law. The Act, however, provides a special rule to cover the possible abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of tax to the trust at its lower progressive rate structure (sec. 644). Under this rule, where the fair market value of property which is placed in trust exceeds the price paid (if any) for the property by the trust (i.e., where there is any bargain element in connection with the transfer) and where the trust sells the property within two years of its transfer to the trust, the tax on the gain (called the "includible gain") to the trust will be equal to the amount of additional tax the transferor would have paid (including any minimum tax [3]) had the gain been included in the gross income of the transferor for his taxable year in which the sale occurred. In essence, the Act treats such gains as if the transferor had realized the gain and then transferred the net proceeds from the sale after tax to the trust as corpus.

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[3] For purposes of computing the minimum income tax portion of the section 644 tax, the amount of tax paid by the transferor shall be deemed to include the tax determined under section 644 other than the portion attributable to the application of the minimum income tax.

However, where the transferor dies before the sale within the two-year period, so that it would not be possible to use the rate brackets of the transferor, the Act makes the provision inapplicable. Consequently, in such a case, the tax on the gain would be taxed at the trust's rates. In addition, in order to prevent circumvention of the two-year period through a short sale during such period, the Act contains a rule which extends two-year period to the closing of the short sale.

For purposes of determining whether the property is a capital asset subject to favorable capital gains treatment, the Act contains a rule under which the character of the property is to be determined by looking to the character of that property in the hands of the transferor. Consequently, where section 644 applies, the gain on the sale of the property will not be entitled to capital gains treatment if the property would not have been a capital asset in the hands of the transferor even if the property is a capital asset in the hands of the trust. In addition, the Act contains a rule which attributes the activities of the trust with respect to the property to the transferor for this purpose. In effect, the provision treats the trust as the agent of the transferor so that the trust's activities are attributed to the transferor.

The "includible gain" is the lesser of the amount of gain recognized by the trust or the amount of gain that the trust would have realized had the property been sold immediately after it was transferred to the trust.[4] Therefore, the transferor cannot use the trust's lower progressive rate structure to tax gain that occurred while he owned the property. Any additional gain that occurs after the property is transferred to the trust is subject to the normal rules for gains realized by the trust.

In order to prevent double taxation of the "includible gain", the Act excludes the includible gain from the taxable income of the trust. Thus, the tax on the remaining income of the trust (including additional gain on the property occurring after the transfer to the trust) will be computed without regard to that includible gain. Similarly, since the includible gain is excluded from the trust's taxable income that gain is not included in the trust's distributable net income and, consequently, the includible gain also will not be taxed to the beneficiary if the gain is currently distributed to him. Moreover, since the includible gain is not in the trust's distributable net income, that gain will not be subject to the accumulation distribution rules (under subpart D) where the gain is first accumulated and then distributed in a subsequent year.

Where the trustee of the trust does not have sufficient information about the transferor to compute the tax on the includible gain, it is expected that the Internal Revenue Service will issue regulations under which the trustee will state in the tax return that he does not have sufficient information and that, in such a case, the Service will compute the tax attributable to that gain. It is also expected that the

[4] Under the Act, the basis of the property for purposes of determining the amount of the "includible gain" is the trusts basis immediately after its transfer to the trust. Consequently, this basis includes any increases in basis under section 1015(d) (relating to increased basis for gift tax paid). The bill also contains special rules where the trust sells the property within the two-year period and elects to report the gain on the installment sales method of accounting (sec. 453). In such a case, the provision is intended to treat each installment as if it were a separate sale or exchange subject to the special two-year rule.

Service will issue regulations providing rules where the transferor has capital or net operating losses and where the transferor's taxable income or tax is affected by subsequent events such as a loss carryback or adjustment by the Internal Revenue Service. The special rule on transfers of appreciated property is not to apply to property placed in charitable remainder trusts or pooled income funds or to property acquired by a trust from a decedent.

There will be some cases where, because the trust is on a fiscal year, it will not be possible for the trustee to ascertain the tax that the transferor would have paid had the transferor realized the gain because the sale occurs within a taxable year of the transferor which ends after the end of the taxable year of the trust in which the sale occurs. For example, assume that the transferor uses a calendar year and the trust uses a fiscal year ended June 30, the transferor transfers appreciated property to the trust in 1977, and the trustee sells the property during the first six months of calendar year 1978. In such a case, the tax return of the trust for the year in which the sale occurred (fiscal year ending June 30, 1978) is due on October 15, 1978. However, the tax return of the transferor for the year in which the sale occurred (calendar year 1978) is not due until April 15, 1979. In such a case, the Act provides a rule under which the trust will report the gain in its tax return due October 15, 1979, but the tax on the gain will be increased by an additional amount representing, in effect, the interest on the one-year delay in reporting the gain. Where the trust terminates during this one-year period, it is contemplated that the Treasury will issue regulations making such gain reportable in the return of the trust for its last taxable year.

Effective date

The amendments made by this provision to the accumulation distribution rules are to apply generally to distributions made in trust taxable years beginning after December 31, 1975. The amendment made with respect to the taxation of gain arising from sales of property within two years of its transfer in trust are to apply to transfers made after May 21, 1976.

Revenue effect

It is estimated that this provision will not have a significant effect on budget receipts.

G. CAPITAL FORMATION

1. Investment Tax Credit—Extension of 10-Percent Credit and $100,000 Limitation for Used Property (secs. 801 and 802 of the Act, sec. 46 of the Code, and sec. 301(c)(2) of the Tax Reduction Act of 1975)

Prior law

Prior to the Tax Reduction Act of 1975, a 7-percent credit was available for qualified property (4 percent in the case of certain public utilities). Investment in qualified used property eligible for the credit was limited to $50,000 per taxable year.

The Tax Reduction Act of 1975 temporarily increased the rate of the investment tax credit for all taxpayers (including certain public utilities) to 10 percent for the period beginning January 22, 1975, and ending December 31, 1976. A corporate taxpayer could elect an 11-percent credit during this period if an amount equal to 1 percent of the qualified investment was contributed to an employee stock ownership plan. Also, in the case of public utilities, the limitation on the amount of tax liability that could be offset by the investment tax credit in a year was increased from 50 percent to 100 percent during 1975 and 1976, and then reduced gradually (by 10 percentage points per year) back to the 50-percent level in 5 subsequent years. In addition, the limitation on qualified investment in used property was temporarily increased to $100,000 until January 1, 1977.

Reasons for change

Real investment in plant and equipment declined severely in 1975, grew rather modestly in 1976, and prospects for a substantial increase in investment in 1977 did not appear to be strong. Real nonresidential fixed investment has fallen from a high of $131 billion in 1973 to an annual rate of $117.7 in the third quarter of 1976. Provision of the 10-percent investment credit over a longer period of time is essential to permit business to properly plan their investment projects without a substantial bunching of projects, which could, in the short run, bid up the price of capital goods. Encouraging investment in new equipment and modernization of existing equipment will improve the long-run ability of the economy to achieve economic growth consistent with past rates of growth without inflationary pressures. Also, increasing aggregate demand by increased investment incentives constitutes an important element in a balanced program of economic recovery.

Explanation of provision

The Act extends the temporary increase in the investment credit to 10 percent for four additional years, through 1980, and similarly extends the increase to $100,000 in the limit on used property through 1980. Under the Act, the credit will revert to 7 percent (4 percent in

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the case of certain public utilities) and the used property limit will drop to $50,000 in 1981.

Effective date

These provisions are effective for taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that these provisions will reduce budget receipts by $1,300 million in fiscal year 1977, $3,306 million in fiscal year 1978, and $2,444 million in fiscal year 1981.

2. First-In-First-Out Treatment of Investment Tax Credits (sec. 802 of the bill and sec. 46 of the Code)

Prior law

In general, the amount of investment credit used in any year cannot exceed $25,000 of tax liability plus 50 percent of any liability in excess of $25,000. (In the case of public utilities, the Tax Reduction Act of 1975 raised the percentage to 100 percent in 1976, 90 percent in 1977, and so forth, dropping back to 50 percent by 1980.) A 3-year carryback and 7-year carryforward is then applied to credits which are not used because of the tax liability limitation. (A 10-year carryforward is available for pre-1971 credits.) Generally, under prior law, investment credits earned in a particular year beginning with 1971 were applied first to the tax liability for that year, after which carryovers and carrybacks of unused credits from other years were applied.

In the case of carryovers of unused investment credits earned in pre-1971 tax years, prior law provided that these credits were to be used before current year credits were used.

Reasons for change

It was brought to the attention of the Congress that many taxpayers with substantial amounts of investment credit carryovers which arose in the past would not be able to use these credits because low levels of taxable income or net operating losses incurred in recent years have prevented use of the credits. Credits arising in the future would completely absorb the limitation and thus prevent the use of the carryovers. The Congress was concerned that the desire of taxpayers to use investment credit carryovers as quickly as possible could significantly dampen the stimulative effect of the investment credit on new investments because these taxpayers may be less likely to make new investments while they have carryover credits which the new investments might cause them to lose.

As a result, the Act changes the general ordering scheme for absorbing investment tax credits to better facilitate the use of carryover credits.

Explanation of provisions

The Act extends the approach adopted for pre-1971 credits (by the Revenue Act of 1971) to require generally that investment credits earned first are to be utilized first regardless of whether the credits were earned in the current year or are carryback or carryover credits. In determining the application of investment credits for a taxable year under this first-in-first-out (FIFO) method, carryover credits from prior taxable years are used first, up to the amount of the tax liability limitation. To the extent the limitation exceeds the amount of carryover credits, current year and then carryback credits may be applied.

An exception to this general rule is provided to reflect Congress' concern that taxpayers be permitted a maximum utilization of their investment credit carryovers under the first-in-first-out method. It was noted that the converse of the general rule, that investment credits earned first will also expire first, while generally applicable, does not result for tax years ending in 1978, 1979, and 1980. This dichotomy arises because pre-1971 credits receive a 10-year carryover while credits earned in later years may be carried over for 7 years. It results, for example, in the expiration of 1971 investment credits at the end of the 1978 taxable year (assuming there are no short taxable periods) while credits earned in 1969 could be carried over not only to 1978 but also to 1979. In order to better enable the earlier expiring (but later earned) investment credits to be used, the Act provides that a carryover of a pre-1971 credit will be postponed to the extent its application in a carryover year will cause all or part of an investment credit from a post-1970 year to expire unused at the end of that carryover year. In the above example, if the limitation for 1978 will not enable both a 1969 credit carryover and a 1971 credit carryover to be absorbed, the 1971 carryover is to be used first after which the 1969 carryover may be used. This provision does not in any way extend the number of carryover years available for investment credits earned under either the 10-year or 7-year rules.

Effective date

These provisions are effective for taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that these provisions will result in a decrease in budget receipts by less than $5 million in fiscal year 1977 and 1978, $5 million in 1979, and $20 million in 1980.

3. ESOP Investment Credit Provisions (sec. 803 of the Act; secs. 46(f), 401(a), 415(c), and 1504(a) of the Code; secs. 301(d) and 301(e) of the Tax Reduction Act of 1975; and sec. 3022(a) of the Employee Retirement Income Security Act of 1974)

Prior law

Employee compensation paid in the form of employer contributions under an employee stock ownership plan (ESOP) is treated as deferred compensation for tax purposes; that is, the employee generally is not taxed on these employer contributions until they are distributed under the plan.

ESOPs are generally designed to be tax-qualified plans. In order to qualify, a plan must, for example, satisfy rules prohibiting discrimination in favor of highly paid employees, and it must meet standards relating to employee participation, vesting, benefit and contribution levels, the form of the benefits, and the security of the benefits. Although, in limited circumstances a contribution to a plan can be withdrawn by the employer if it is made by mistake, the tax law does not permit withdrawal of a contribution merely because it is not deductible.

Under the tax law, if a plan meets these requirements, in addition to deferral of employee tax on employer contributions the employer is allowed a deduction (within limitations) for his contributions for the year the contributions are made, the income earned on assets held under the plan is generally not taxed until it is distributed, special 10-year income averaging rules and nonrecognition of gain rules apply to distributions made in a lump sum, and estate and gift tax exclusions may be provided.

An ESOP uses a tax-qualified stock bonus plan [1] or a combination of a qualified stock bonus plan and a qualified stock money pension plan.[2] It is a technique of corporate finance designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay on their part, any reduction in pay or other employee benefits, or the surrender of any rights on the part of the employees.

Under an ESOP, an employee stock ownership trust generally acquires stock of the employer with the proceeds of a loan made to it by a financial institution. Typically, the loan is guaranteed by the employer. The employer's contributions to the employee trust are applied to retire the loan so that, as the loan is retired, and as the value of the employer stock increases, the beneficial interest of the employees increases. Of course, if the employer fails to make the required contributions, or if the value of the employer's stock declines, the beneficial interest of the employees declines.

Under prior law, if a qualified investment were made before January 1, 1977, an extra percentage point of investment credit (11 percent rather than 10 percent) was allowed where the additional credit amount was contributed to an ESOP which satisfied the requirements of the Tax Reduction Act of 1975. Under that Act, the ESOP, whether or not tax-qualified, must satisfy special rules as to vesting,[3] employee participation,[4] allocation of employer contributions,[5] benefit and contribution limits,[6] and voting of stock held by a trust under the plan.[7] The vesting, allocation, and voting rules are generally con-

[1] A qualified stock bonus plan is required to distribute benefits in the form of employer stock.

[2] A pension plan which invests in employer securities, and under which employer contributions are credited to the separate accounts of employees. An employee's benefits under such a plan are based upon the balance of his account.

[3] Each participant's right to stock allocated to his account under these rules must be nonforfeitable..

[4] The ESOP must satisfy the same participation rules applicable to qualified plans.

[5] An employee who participates in the plan at any time during the year for which an employer contribution is made is entitled to a share of the employer contribution, based upon the amount of compensation paid to him by the employer. Only the first $100,000 of employee compensation is considered for purposes of the plan.

[6] The ESOP is subject to the same benefit and contribution limitations applicable to qualified plans.

[7] Employees must be entitled to direct the voting of employer stock allocated to their accounts under the employee trust. The plan need not permit employees to direct the voting of unallocated employee stock held by the trust.

sidered more favorable to rank and file employees than those which have been required for tax qualification.

Reasons for change

Several problems arose under the prior investment tax credit rules designed to encourage the adoption of ESOPs. For example, because the additional investment tax credit was only available for a short period, many employers did not become aware of it in time to establish an ESOP. This lag in recognition of the new provisions and uncertainty as to how they would be applied probably accounts for the modest number of ESOPs established under the prior investment tax credit rules. Also, because of the short period during which investments could qualify for the additional credit, some employers found that the cost of establishing an ESOP under the investment tax credit rules was unreasonably high in relation to the benefits of the plan.

The investment tax credit recapture and redetermination rules were another factor which discouraged the adoption of ESOPs. Under those rules, if a portion of the additional investment tax credit was recaptured or the credit was redetermined by the Internal Revenue Service to be a smaller amount than claimed, the employer had to bear the cost of repaying the excess credit; it could not recover that cost directly or indirectly from an employee trust under an ESOP.

Special problems discouraged the adoption of ESOPs by regulated utilities. Publicly regulated utilities were reluctant to establish ESOPs under the investment tax credit rules because they were concerned that regulatory commissions would require that the additional investment tax credit be "flowed-through" to customers. If the regulatory commissions took that position, the utilities would be required, in effect, to pay out the additional investment tax credit twice—once to the ESOP and then again to the customers.

Explanation of provisions

(a) General Rules

Effective for years beginning after 1976, the Act extends the additional one-percent credit program to qualified investments made before January 1, 1981. Also, if an employer supplements its contributions under the one percent credit program by matching employee contributions to the ESOP, beginning in 1977 the Act allows an extra investment credit (up to an extra one-half percentage point of qualified investments) for the employer's supplementary contributions which are matched by employee contributions. Under the Act, separate accounting is required for matching employee and employer contributions. Continuing prior law treatment, an employer contribution for a taxable year in excess of the amount attributable to the additional credit allowed for that year is deductible for that year, subject to the usual rules for deduction of contributions to employee plans.

Under the Act, employer and employee contributions are subject to the overall benefit and contribution limitations applicable to employee plans. (The Act continues prior law under which employer contributions to investment credit ESOPs were subject to these limitations.)

The limitations may restrict the amount of the additional one-half percent investment credit allowable.

The Congress intends that employee contributions can be taken into account for the additional credit if they are contributed to the plan before the end of the year in which the credit is allowed or if the contributions are pledged by the employees to be paid within 2 years after the close of that year and the pledge is made before the return for the year is filed. If employee contributions are made in excess of the amount pledged and are matched with employer contributions. additional credit can be claimed by the employer for the year the qualified investment was made. Under the Act, employee contributions made under the matching rules are to be invested in employer securities under the same rules that apply to employer contributions.

Also, under the Act, employee contributions to an investment credit ESOP are subject to the same antidiscrimination rules as apply to employee contributions under a tax-qualified pension plan, and matched employee contributions are subject to the same restrictions on distribution as employer contributions of investment credit (generally, no withdrawal is permitted for 84 months).

Under the Act, employee contributions cannot be compulsory; that is, employee contributions may not be made a condition of employment or a condition of participation in the plan. Of course, the level of employer-derived benefits under the matching rules depends upon employee contributions.

Flow-through of investment tax credit.—Because the entire additional investment tax credit is intended to go to the employees participating in an ESOP, the Act provides that the entire investment credit is not available to a company if a public service commission requires a utility to flow through any part of that additional credit (claimed for taxable years ending after 1975) to the consumer.

Recapture and redetermination of tax credit.—Where an investment credit is subject to recapture or a company's income or investment is redetermined with the result that the investment tax credit is decreased, under the Act, the amount of decrease can be applied to offset employer contributions for other years. Alternatively, the Act allows a deduction for disallowed or recaptured credit which was contributed to an ESOP. As a further alternative, the Act permits an employer to recover recaptured credit from an ESOP. (See "*Withdrawal of contributions*" below.)

Time of contribution.—Where the full amount of investment tax credit is not allowed for a year because the credit is limited on the basis of the tax for the year, the Act provides that the additional credit can be contributed to the plan as it is allowed. Also, the Congress intended that if the investment credit is carried back from the year of investment in qualifying property to a prior year, the additional investment credit which is allowed as a result of the carryback is to be contributed to the ESOP for the year of the investment and is to be allocated to plan participants in the same manner as if it had been allowed in the year of investment.

Administrative expenses.—Limited amounts of "start up" and administrative expenses for establishing an ESOP can be charged against the additional investment credit contributed to an ESOP. The maximum amount of start up costs which may be charged is 10 percent of the first $100,000 of the amount required to be transferred to the ESOP for the taxable year for which the plan is established, and 5 percent of any additional amount for such year. In addition, under the provision, on-going costs of administration (up to 10 percent of the first $100,000 of the trust's dividend income plus 5 percent of the remaining dividend income, but in no event more than $100,000) may also be charged to an ESOP.

Definition of employer securities.—In order to extend the benefits of employee stock ownership to "brother-sister" corporations and "second-tier" parent-subsidiary groups, the provision permits the stock of a member of a controlled group of corporations to be used as employer securities for another member of the group. This rule also permits the stock of a parent corporation to be used as employer securities with respect to a subsidiary where the parent owns 80 percent or more of the subsidiary's voting stock but does not own at least 80 percent of the subsidiary's nonvoting stock which is limited and preferred as to dividends. In this situation, the subsidiary's stock could also be used as employer securities.

Consolidated returns.—The Act provides that the rules for determining whether there is a sufficient affiliation between corporations to permit the filing of a consolidated return are applied without regard to employer securities held by an ESOP.

Compensation.—Under the provision, a participant's compensation is defined to be the same as under rules of the Code which limit contributions to qualified plans (sec. 415).

Permanent plan.—The Act makes clear that an ESOP which satisfies the investment tax credit rules does not fail to be a permanent program merely because employer contributions are not made for a year if the additional investment tax credit is not available for the year (for reasons other than the employer's failure to make the contribution).

Other provisions.—In situations where the value of employer stock can be expected to increase rapidly, the rule of prior law limiting the annual addition to the account of a participant in a defined contribution plan to $25,000 (plus a cost-of-living adjustment) may discourage the establishment of an ESOP designed to acquire employer stock from a present shareholder by causing the shareholder to suffer an unacceptable level of dilution of his interest in the company. In order to remove this barrier to ESOPs, the Act doubles the dollar limitation provided by present law in the case of defined contribution plans but the additional amount may only consist of employer securities. Also, under the Act, the limitation on benefits which may be provided under a defined benefit plan would be reduced where the additional defined contribution limitation is allowed for an ESOP. In order to assure that the doubled allowance is not available to a plan unless rank-and-file employees are the chief beneficiaries of the plan, however, under the Act the doubled allowance is not available for a plan if more than one-third of the employer contributions to plan for a year are allocated to employees who are officers or shareholders, or whose compensation for the year exceeds twice the amount of the dollar limitation ordinarily applicable to the annual addition to the account of a participant in a defined contribution plan. (This is not intended to affect any determination of which employees are considered highly compensated for purposes of the coverage and nondiscrimination requirements applicable to qualified plans generally.) For this purpose, employees who hold 10 percent or less (determined with attribution rules) of the employer's stock (outside of the ESOP) are not considered shareholders.

Withdrawal of contributions.—If the plan provides, the Act permits funds contributed by the employer to be withdrawn from an investment credit ESOP (1) to refund employer contributions which are not matched by employee contributions within the period specified, or (2) to permit the employer to recover from the ESOP any portion of the employer's contribution which is recaptured from the employer under the investment credit rules (for example, where the property for which the credit is claimed is disposed of prematurely). The Act provides that the withdrawal of employer contributions made under the one-half percent credit rules because they are not matched by employee contributions, or a recovery of employer contributions under the recapture rules, will not cause the plan to be considered as other than for the exclusive benefit of employees and that employee rights to employer-derived benefits under the plan will not be considered forfeitable merely because employer contributions of investment credit may be withdrawn under the matching or recapture rules. The Act does not permit an employer to recover recaptured investment credit unless the employer contributions for each year are separately accounted for (all contributions made before enactment of the Act can be aggregated for this purpose).

Under the Act, employee funds contributed to an investment credit ESOP are subject to employee withdrawal unless they are matched by employer contributions under the one-half percent credit rules. For example, if matching employer or employee contributions cannot be made because of the overall limitations on benefits and contributions (sec. 415 of the Code), the unmatched employee contributions would be refunded to the employee (unless he instructs the plan to the contrary).

(b) Employee Stock Ownership Plan Regulations

The Act reaffirms Congressional intent with respect to employee stock ownership plans and expresses concern that administrative rules and regulations may frustrate Congressional intent. In this connection, it has come to the attention of the Congress that proposed regulations issued by both the Department of the Treasury and the Department of Labor on July 30, 1976, may make it virtually impossible for ESOPs, and especially leveraged ESOPs, to be established and function effectively. The following areas are of specific concern to the Congress.

(1) *Independent third party.*—The proposed rules would prohibit loans (or loan guarantees) by fiduciaries to employee stock ownership plans unless the loans are arranged and approved by an independent third party. These rules would, for example, prevent a bank which serves as trustee for an ESOP from making a loan to the plan and would prevent the employer-fiduciary who established the plan from providing a loan guarantee.

In view of other rules presently in effect, which require that the interest rate for any such loan be reasonable, that the loan be primarily for the benefit of participants or their beneficiaries, and that the only collateral the plan can give the lender is the employer's stock purchased with the loan proceeds, the requirement of an independent third party is unduly burdensome. Consequently, the Congress believes that the regulations should deal directly with possible abuses which may occur in the administration of plans rather than attempting to require a plan to incur the burden of dealing through an independent third party. Similarly, the Congress believes that an independent third party should not be required to arrange and approve a sale of stock between an employer (or shareholder of the employer) and an ESOP. The Congress has not considered whether the principles applicable to ESOPs in connection with loans to the plan or sales of employer stock should apply in the case of other exemptions from the prohibited transaction rules and, accordingly, no inference should be drawn regarding those other exemptions.

(2) *Put option.*—The proposed regulations would require that an employer provide each employee who receives stock from a leveraged ESOP or an investment credit ESOP with a 2-year "put option" if the stock is not listed on an exchange.

Although the Congress agrees that a market should be provided for employer stock distributed by an ESOP to an employee, the Congress believes that a put option for a period considerably shorter than two years will properly protect employees and that a put under which the employer must pay for tendered stock over too short a period would effectively deny the employer the benefits of capital formation the Congress sought to provide under an ESOP. On the contrary, the Congress believes that the payment by the employer could be made in substantially equal installments over a reasonable period, taking into account the need to protect the interests of employees and the need of the employer for capital.

(3) *Stock purchased with loan proceeds.*—Under the proposed regulations, if an ESOP holds employer stock which it purchased with the proceeds of a loan, the stock is to be placed in a suspense account from which it is to be released under a formula. The formula provided by the proposed regulations, however, is not in accordance with the common business practice under which the stock is released from the account as loan principal is amortized.

The Congress believes that the regulations should allow the stock to be released as the loan principal is repaid if (a) the principal is amortized over a reasonable period (taking into account the facts and circumstances, including the interests of plan participants and the employer's need for capital), and (b) the employees are adequately informed regarding their rights to employer stock held by the plan.

(4) *Allocation of stock.*—Under the proposed regulations, employer stock acquired by an ESOP with loan proceeds must be allocated to plan participants as it is released from the suspense account discussed in (3) above. The Congress believes that the regulations should permit the allocation of stock to be made in accordance with a formula more similar to that provided for ESOPs in the Trade Act of 1974 (19 U.S.C. § 2373(f)(4)).

(5) *Voting rights.*—The proposed regulations would require that employees be permitted to direct the voting of employer stock allo-

cated to their accounts under a leveraged ESOP even though other types of employee plans need not provide employees with these rights. (The Tax Reduction Act of 1975 requires that employees be permitted to direct the voting of employer stock allocated to their accounts under an investment credit ESOP but not under other ESOPs.) The Congress believes that the regulations should not distinguish between leveraged ESOPs and other employee plans in this regard.

(6) *Dividend restrictions.*—Under the proposed regulations, employer stock held by an ESOP must have unrestricted dividend rights. However dividend restrictions are commonly required in connection with loans. Consequently, the Congress believes that such restrictions should be permitted if they are required in connection with a loan to the ESOP for the purchase of employer securities (but only if the restrictions terminate when the loan is repaid) or if they apply also to a significant portion of the employer stock not held by the ESOP.

(7) *Right of first refusal.*—The proposed regulations prohibit a leveraged ESOP from acquiring, with the proceeds of a loan, employer stock subject to a right of first refusal. Because the shareholders of many corporations (especially smaller businesses) believe that a right of first refusal is necessary to protect their interests, the Congress believes that the prohibition will have a chilling effect upon the establishment of ESOPs and that a right of first refusal should not be proscribed.

(8) *Treatment of sale as redemption.*—Under the proposed regulations, the sale of stock by a corporate shareholder to the corporation's ESOP could, depending upon the facts and circumstances, be treated as a redemption of the stock by the corporation. If the sale is treated as a redemption, the proceeds of the sale could be considered dividend income rather than capital gain. The Congress believes that if such a rule is authorized and proper, its application should not be restricted to ESOPs and that it should be applied only where the stock sold by the shareholder inures to his benefit (or the benefit of related parties) under the plan.

(9) *Nonvoting common stock, etc.*—The proposed regulations impose special rules on ESOPs which limit the extent to which the plan can acquire employer securities, other than voting common stock with unrestricted dividend rights, with the proceeds of a loan. (The Tax Reduction Act of 1975 does not allow the additional investment credit for nonvoting employer stock.) The Congress believes that the usual rules applicable to employee plans properly protect the interests of plan participants and that these special rules are not needed.

(10) *Prepayment penalty.*—The proposed regulations specifically prohibit any loan made to an ESOP from containing a provision for a prepayment penalty. The Congress believes that the question of such penalties should be a matter of negotiation between the ESOP and the lender and that prepayment penalties should not be prohibited in all cases. (They should not be allowed of course if, for example, payment of a penalty would be imprudent.)

(11) *No calls or other options.*—The proposed regulations prohibit stock acquired with an ESOP loan from being subject to any calls or options (other than the put option described in (2) above). There is no provision for restrictions which may be required by State or Federal

law. The Congress believes that in the limited situation where restrictions are imposed by law, stock in an ESOP should be permitted to have restrictions necessary to comply with the law.

(12) *Comparability.*—The proposed regulations do not permit an ESOP and another plan to be considered a single plan for purposes of determining whether the plans meet the anti-discrimination requirements of the tax law. Although the Congress agrees that an ESOP and another type of plan should not be considered a single plan for this purpose, the Congress believes that this rule should not be applied to disqualify a plan already in existence and that two or more ESOPs can be considered as a single plan in testing the coverage and contributions or benefits under the plans.

As stated in the Report of the Senate Finance Committee on the bill, an ESOP is designed to "build equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes." (S. Rept. No. 94–938, p. 180.) The Congress understands that, under the proposed regulations, an ESOP could be integrated with the social security system so that employer stock would not be allocated to employees substantially in proportion to their compensation. The Congress believes that social security integration is not consistent with the purposes of an ESOP. The Congress believes, however, that a prohibition on integration should not apply to ESOPs which were integrated at the time the Act was enacted.

(13) *Inferences.*—Although the Congress has commented on the merits of the proposed regulations, these comments should not be taken as inferring approval or disapproval of the provisions not commented upon.

(c) Study of Expanded Stock Ownership

The Act changes the name of the existing Joint Pension Task Force to the Joint Pension, Profit-sharing and Employee Stock Ownership Plan Task Force, and provides that the Task Force is to study employee stock ownership plans. The Task Force, which may consult others who have information concerning employee stock ownership plans, is to report its findings to the Committee on Ways and Means and the Committee on Education and Labor of the House and the Committee on Finance and the Committee on Labor and Public Welfare of the Senate by March 31, 1978.

Effective date

The additional one-half percent investment tax credit applies for taxable years beginning after December 31, 1976. The investment credit "flow through" provisions apply for taxable years beginning after December 31, 1975. The special limitation on contributions for ESOPs applies for taxable years beginning after December 31, 1975. The other provisions generally apply for taxable years beginning after December 31, 1974.

Revenue effect

The general provisions for the one and one-half percent investment credit ESOPs are expected to decrease revenue by $107 million in fiscal 1977, $257 million in fiscal 1978, $303 million in fiscal 1979, $332 million in fiscal 1980, $189 million in fiscal 1981. The regulations and study provisions have no effect on revenue.

4. Investment Credit in the Case of Movies and Television Films (sec. 804 of the Act and sec. 48 of the Code)

Prior law

Under the tax law, taxpayers are entitled to receive an investment credit for tangible personal property (i.e., section 38 property) which is placed in service by the taxpayer. In order to receive the full credit, the property placed in service by the taxpayer must have a useful life of at least 7 years. If the property has a useful life of at least 5 years (but less than 7 years) the taxpayer is entitled to two-thirds of the full credit. If the property has a useful life of at least 3 years (but less than 5 years) the taxpayer is entitled to a one-third credit. In addition, there cannot be any predominant foreign use of the property during any taxable year, or the property will cease to qualify as section 38 property.

Prior to 1971, it was not clear whether (and if so, under what conditions) the investment credit was available for movie or television films. However, a court case had held that movie films were tangible personal property eligible for the investment credit. During the legislative consideration of the Revenue Act of 1971, it was made clear that motion pictures and television films are to be treated as tangible personal property eligible for the investment credit (i.e., section 38 property). However, this issue was still being litigated for years prior to 1971, and there were still a number of other unsettled issues, such as how to determine the useful life of a film, the basis on which the credit is to be computed, and how to determine whether there has been a predominant foreign use of the film.

Reasons for change

Due to the uncertainties of prior law with respect to the questions of useful life and predominant foreign use, it was often difficult to determine whether a film was entitled to a full credit, a partial one-third or two-thirds credit, or possibly no credit. Congress felt that it was desirable to clarify these issues, in order to avoid costly litigation with respect to the past, and to allow accurate investment planning for the movie industry in future years.

To achieve the objective set out above, the Act, for past years, allows taxpayers to determine their investment credit on a film-by-film basis in accordance with certain statutory rules prescribed under the Act with respect to useful life and predominant foreign use, or to elect to take a 40-percent compromise credit for all their films, regardless of the actual useful life or foreign use of any particular film. The Congress believes that this 40-percent figure represents a fair compromise between the litigating position of the Internal Revenue Service, on the one hand, and members of the industry, on the other hand.

In addition, since the major purpose of the investment credit is to create jobs in the United States, the Act provides that for the future the amount of the investment credit in the case of movie films is to depend on the place of production of the film (i.e., United States or foreign), rather than on the place where revenues are received for showing the film. Thus, the foreign use test will not apply to movie films for the future. As a further incentive to encourage U.S. production of films, the Act provides that where 80 percent or more of the direct production costs of the film are U.S. costs, the credit base for the film is to include certain indirect costs (such as general overhead costs, the cost of screen rights, etc.), but that otherwise the credit base will be limited to direct U.S. production costs.

As to the issue of useful life, taxpayers may take a two-thirds credit on all their films (regardless of the useful life of particular films), or they may elect to determine useful life on a film-by-film basis. Under this latter method of computing the credit, the useful life of the film will be treated as having ended when 90 percent of the basis of the film has been recovered through depreciation.

Explanation of provisions

As outlined above, the Act provides somewhat different rules in this area with respect to the past than it does for the future, because the rules for the past are intended to be a compromise of the litigating positions of the Internal Revenue Service and members of the film industry, based on transactions which have already occurred. Also, the rules are different for the future because the emphasis for the future is to be on providing jobs in the United States.

Films placed in service in future years

General rule.—For the future, as a general rule, under the Act, taxpayers are to receive two-thirds of a full credit for all their films regardless of the actual useful life (or foreign use) of any particular film. This rule will apply to all films placed in service (i.e., initially released for public exhibition in any medium) in taxable years beginning after December 31, 1974, regardless of whether any particular film had a useful life of 7 years or more (so that it would be entitled to a full credit if judged on an individual basis), or less than 3 years (so that it would not be entitled to any credit if judged separately). The credit is to be available only for "qualified films", i.e., motion picture films or television films or tapes created primarily for use as public entertainment, and educational films, i.e., generally films used in primary or secondary schools, colleges and universities, vocational and post-secondary educational institutions, public libraries and government agencies (thus, for example, excluding industrial training films). Also, the credit would be available for TV pilot films and dramatic or comedy series, such as "Mod Squad" or "The Mary Tyler Moore Show." However, the credit would not be available for films which were topical or transitory in nature, such as news shows, interview shows such as "Johnny Carson" or "Firing Line", or films or tapes of sports events, even though some of these shows might be shown in subsequent years. Also, the credit would not be available for used films (i.e., films shown previously in any market).

The 90-percent method.—Under the Act, as an alternative to the general rule, taxpayers may elect to have the investment credit determined for all of their qualified films placed in service in the future on a film-by-film basis. Thus, if a particular film had a useful life of 7 years or more, the taxpayer would be entitled to a full credit for that film. On the other hand, if a film had a useful life of less than 3 years the taxpayer would not be entitled to any credit for that film. For purposes of these rules, the film's useful life is to be treated as ending at the close of the year by the end of which the aggregate allowable deductions for depreciation equal at least 90 percent of the basis of the film (adjusted for any partial dispositions, but determined without regard to any other adjustments).

For example, assume that a taxpayer who is on a calendar year basis releases (i.e., places in service) a film with a basis of $100 on February 1, 1975. The film is depreciated under the income forecast method and $50 of depreciation is allowable with respect to this film for 1975, $30 for 1976 and $10 is for 1977. Thus, $90 of depreciation is allowable by the close of 1977, and since this represents 90 percent of the basis of the film the useful life of the film is to be treated as having ended on December 31, 1977, or less than three years after the film was placed in service; therefore, no credit would be available with respect to this film, and any credit or partial credit which had been claimed would be subject to recapture.

On the other hand, if less than $90 of basis had been recovered by the close of 1977, the film would be eligible for at least a partial credit.[1]

Of course, films of a transitory or topical nature would not be eligible for the investment credit, no matter when their basis was recovered through depreciation.

If the actual useful life of a film is less than its anticipated useful life in the case of a taxpayer using the 90-percent method, the credit is to be subject to recapture under essentially the same rules which apply in the case of any other section 38 property where the actual useful life proves to be shorter than the anticipated life. Also, in the case of a disposition or partial disposition of rights in the film before the end of the anticipated useful life of the film, there would be a full or partial recapture.[2]

A partial disposition includes the sale of commercial exploitation rights in any medium (television, for example) or in any geographic area (such as Great Britain, or any other foreign country). On the other hand, an ordinary commercial license for less than the full rights of exploitation in a particular medium or area generally does not constitute a disposition or partial disposition for purposes of these rules.

Also, a sale of exploitation rights to a member of an "affiliated group" does not constitute a partial disposition. For example, U.S. film distributors commonly exploit the foreign rights to a U.S.-made film through use of a foreign affiliate. For purposes of these rules, the term "affiliated group" is to have the same meaning as it does for purposes of section 1504, but with a 50-percent control test (instead of 80 percent), and with no exclusion of corporations (such as foreign affiliates) described in section 1504(b). Also where stock in a foreign film distributor is held by the trust of a pension plan which benefits the employees of that foreign distributor, any U.S. corporation holding stock in the foreign distributor may add the stock held by the pension trust to its own stock holdings for purposes of determining if the foreign film distributor is an "affiliate" of the U.S. corporation. For example, if two American distributors each hold 49 percent of the stock in a foreign distributor, and the pension trust of the foreign distributor holds the remaining 2 percent, the foreign distributor would be an affiliate

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[1] For purposes of these calculations, salvage value would not be taken into account: thus, if a film has a basis of $100, and a salvage value of $10, the useful life would not end until $90 of depreciation was recoverable (i.e., 90 percent of the $100 basis, not 90 percent of the $100 basis minus the $10 salvage value, which would equal $81).

[2] This rule is not to apply to a taxpayer using the general rule (the two-thirds method), however, since the amount of the credit under this method does not depend on the useful life of any particular film.

of both the American corporations (because each would add the 2 percent interest held by the pension trust to its own 49-percent interest).

Some of the principles above may be illustrated as follows. A film distributor having a 100-percent ownership interest in a television dramatic series, consisting of 24 weekly episodes, elects to use the 90-percent method of determining its investment credit for movie films. The distributor estimates the useful life of the series will be 7 years or more and claims a full credit. The distributor licenses a United States television network; under the agreement the network acquires first-run U.S. television rights for $100, with the right to repeat each episode over the network one time for an additional fee of $25.

In the following year,[3] the American distributor sells the exclusive rights to exhibit the series in Great Britain to a British corporation which is not affiliated with the American distributor. This constitutes a partial disposition of the series which triggers a partial recapture of the credit.

If, on the other hand, the American distributor entered into a limited licensing agreement with the foreign corporation (similar to the agreement which it had entered with the American network), or sold the British rights to the series to a member of an affiliated group, there would be no partial disposition, and consequently, no recapture.

Films placed in service for taxable years beginning after December 31, 1974, are not subject to the foreign use rule. This is because, in the case of a movie film, jobs are created where the film is produced, not where it is shown. To use the 90-percent method, the taxpayer would have to make an election, in a time and manner to be prescribed in regulations.

Once the taxpayer (or any related business entity) has operated under the general rule for the future, or has elected to use the 90-percent method, he cannot change his method of operation without the consent of the Internal Revenue Service. The Congress intends that permission will be granted where the taxpayer undergoes a substantial transformation in its operations, but generally will not be granted otherwise. For example, it might be appropriate to grant permission if a film studio using the 90-percent method merged with a studio using the two-thirds method; or in cases where a studio shifted from the production of short-lived grade B westerns to long-lived classic films.

For purposes of these rules, related business entities include all component members of a controlled group of corporations (within the meaning of section 1563(a), without regard to subsection 1563(b)(2)) but subject to a 50-percent control test. Also classified as "related business entities" are any corporations, partnerships, trusts, estates, proprietorships, or other entities, if "related persons", each of whom have at least a 10-percent interest in each entity, also have, in the aggregate, at least 50 percent of the beneficial interests in those entities.[4]

Thus, for example, if individuals A, B, C, and D each have a 25-percent interest in studio 1 (which uses the two-thirds method in 1975),

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[3] Where a TV series is involved, each weekly segment is placed in service when it is first shown. Thus, the various segments of the series will not necessarily be placed in service in the same year.

[4] The term "beneficial interest" means voting stock in the case of a corporation, profits or capital interest in the case of a partnership, and beneficial interest in the case of a trust or estate. "Related persons" are generally as described in section 267 or 707(b), but for purposes of these rules members of a family consist only of the individual, his spouse, and his minor children.

studio 2, formed in 1976, with A and B each having a 50-percent profits interest, cannot elect the 90-percent method for 1976 without the permission of the Internal Revenue Service. Studio 1 and studio 2 are related, because A and B each have at least a 10-percent interest in both studios and together A and B have at least 50 percent of the beneficial interest of both studios. Since studio 1 used the two-thirds method in 1975, studio 2 must have permission to use a different method in 1976.

Credit base.—Since the primary purpose of the investment credit is to create jobs, the Act is designed to encourage the production of films in the United States. Thus, the credit base for motion picture films includes the direct costs which are allocable to production of the film in the United States (including Puerto Rico and the possessions) and, in addition, if at least 80 percent of the direct production costs are allocable to United States production, the credit base also includes certain indirect "production costs."

Direct production costs include compensation payable to the actors and other production personnel. However, under the Act certain special rules apply in the case of participations (described below in connection with indirect production costs).

Direct production costs also include expenses for costumes, props, scenery, and similar items, as well as the cost of the film, and the cost of preparing the first distribution of prints (i.e., prints placed in service within 12 months after the film is first released).

Where the film is produced partly in the United States and partly abroad, the direct production costs must be allocated between the U.S. and foreign production of the film. Under the Act, compensation for services is to be allocated to the country where the services are performed. However, compensation paid to United States citizens is to be allocated to the United States, even if the services are performed outside of the United States. Also, payments to a subchapter S corporation or to a partnership are to be treated as United States production costs if (and to the extent) that the payments are includable in gross income by a U.S. citizen or any other United States person (which is not a partnership or subchapter S corporation). Amounts paid for equipment and supplies are to be allocated to the country in which the materials are predominantly used (where this can be established for particular materials). Subject to these guidelines, allocation of direct production costs is to be determined under regulations. The Congress intends that generally (in the absence of better evidence as to the actual place of predominant use of personnel and materials) direct production costs are to be allocated in accordance with the shooting time of the film.

If 80 percent or more of the direct production costs are allocable to U.S. production, then the credit base for the film is to include all "production costs" of the film (other than the direct foreign production costs, if any). These would include not only the direct production costs, as outlined above, but also certain capitalized costs, including a reasonable allocation of the general overhead of the taxpayer, the cost of obtaining the screen rights to the film, as well as the cost of developing the screenplay, and "residuals" (whether or not capitalized) paid under agreements with labor organizations, such as the Actor's Guild.

Generally, residuals are amounts paid under a collective bargaining agreement to all members of the union involved (or in some cases to a guild or union pension, health, or welfare fund). The collective bargaining agreement generally covers all films produced over a period of several years. Residuals may be a percentage of gross receipts from nontheatrical uses of a theatrical film, or a percentage of the minimum salary payable (i.e., scale) to the union member.

Under the Act, participations may be included in the credit base of an 80 percent or more U.S. produced film subject to certain limitations. First, participations may be included in the credit base only to the extent that participations paid to any one person in connection with any one film do not exceed $1 million.[5] Subject to this rule, participations are includible in the investment credit tax base to the extent of the lesser of: (1) 25 percent of participations qualifying under the $1 million limitation, or (2) 12½ percent of the production costs of the taxpayer's films for the year (i.e., his investment credit tax base determined without regard to participations or residuals). These limitations are to be applied on a vintage year basis (i.e., participations in films released in the same year are to be considered in the aggregate for purposes of determining whether the 12½-percent limitattion with respect to those films has been exceeded).

If less than 80 percent of the direct production costs of a film are allocable to U.S. production, then the credit base with respect to that film includes only the direct U.S. production costs.

Some of the principles discussed above may be illustrated as follows. Assume that the total production costs of a film equal $150. Of this amount, $50 are indirect production costs, including $30 for general overhead, $10 for the screen rights and $10 of residuals. The direct production costs include $75 of salary and $25 for supplies and materials. Fifty dollars of compensation are paid to United States citizens, and $25 of compensation are paid to non-U.S. actors and production crew, and these individuals perform services both in the U.S. and abroad. Of the $25 used for costume and supplies, $10 are paid for supplies used only in the United States, $5 are paid for costumes used only in a foreign country, and $10 worth of supplies are used both in domestic and foreign shooting. Sixty percent of the shooting time for the film occurs in the U.S., and 40 percent occurs abroad. The calculation is as follows:

U.S. COSTS		FOREIGN COSTS	
Compensation paid to U.S. citizens	$50		$00
60 pct. of compensation paid to non-U.S. citizens	15	40 pct. of compensation paid to non-U.S. citizens	10
Supplies used only in United States	10	Supplies used only abroad	5
60 pct. of the cost of supplies used in the United States and abroad	6	40 pct. of the cost of supplies used in the United States and abroad	4
Total	81	Total	19

Since 81 percent of the direct cost of production is allocable to United States production, the credit base also includes the $50 of indirect pro-

[5] These rules affecting participations apply only for purposes of the investment credit tax base and no inference is intended that similar rules should be applied for other purposes under the tax law (i.e., the taxpayer's basis for depreciation). The Congress intends that such questions be determined under the rules of the tax law without regard to this provision.

duction costs. However, the $10 cost for residuals is not to be eligible for the credit until the year in which these amounts are actually paid.

Of course, under the Act, where a film is purchased before it is placed in service in any medium, the credit base cannot exceed the purchase price of the film (if this is less than the credit base for the film as computed under the rules outlined above).

Under certain circumstances, it may be possible for the rights to the film to be leased under section 48(d) before the film is placed in service. However, it is intended that the credit is to be available to the lessee only where the lessee acquires full rights to exploit the movie or film for its estimated useful life through a particular medium or in a particular geographic area; it is not to be available where the lessee is precluded (by law, regulation or governmental action) from acquiring all rights to exploit the film or tape commercially. Also, in the case of the transfer of a film to a lessee (under section 48(d) of the Code), the lessee is generally to be treated as having acquired the film for an amount equal to the lessor's credit base with respect to that film (rather than its fair market value).

The rules outlined above concerning the credit base apply regardless of whether the taxpayer uses the general rule (two-thirds method) or the 90-percent method.

Who is entitled to the credit.—Under the Act, a taxpayer is to be entitled to the investment credit for a movie film if, and to the extent, that he has an "ownership interest" in the film at the time it is placed in service. For purposes of these rules, a taxpayer will be treated as having an ownership interest to the extent that his capital is at risk.

Thus, if the expenses of producing a movie are incurred by the producer, but are reimbursed by the distributor, either by means of a nonrecourse loan or otherwise, the distributor would be entitled to the credit, because the distributor's capital is at risk. Also, if the production costs are paid from the proceeds of a nonrecourse loan supplied by a bank but guaranteed by the distributor, then the distributor would be entitled to the credit because its capital was at risk in connection with the film. A similar result would follow if the producer was liable to the bank on the loan, but the distributor had contracted to pay at least the amount of the loan to the producer in connection with the film.

The determination as to whose capital is at risk in connection with the film (and, therefore, as to who is entitled to the credit) is to be made as of the time the film is first placed in service (*i.e.*, released). Thereafter, the film would be considered used property, which is not to be eligible for the credit under the Act.

Generally, where the distributor has borne the cost of producing a film, and first releases it through the medium of movie houses, it is the distributor who is entitled to the credit. In the case of a film or series which is made for television, the producer-distributor will also generally be entitled to the credit where the film is exhibited over the network pursuant to a licensing agreement. On the other hand, if the network purchased all rights to the film or series before it was placed in service, the network would be entitled to the credit.

It is possible that more than one taxpayer may be entitled to a share of the credit for the same film as, for example, where several investors put up a portion of the capital needed to produce the film pursuant to a joint venture agreement. Generally, where more than one party bears the risk of loss with respect to a particular film, the Secretary of the Treasury or his delegate may establish procedures for determining who is entitled to the credit, or partial credit. (Of course, where there are several parties to a transaction involving a movie film, and one party is entitled to the investment credit with respect to that film under these rules, whereas the other party is not, the Congress anticipates that the availability of the investment credit may often be taken into account by the parties in determining their contract arrangements.)

It is also possible that more than one taxpayer may be entitled to the credit for a particular film where the film is placed in service in more than one medium or more than one geographic area. For example, suppose that a producer creates a U.S.-produced film having a credit base of $100. A distributor acquires exclusive perpetual distribution rights within the United States in exchange for a lump-sum payment of $50 and the film is subsequently placed in service. The distributor is entitled to a credit with respect to the film based on his cost of $50 in acquiring the U.S. rights. The producer, who retains the other rights to the film, would also be entitled to a part of the credit based on his capital at risk. The producer's credit base would be computed by subtracting the cost borne by the U.S. distributor ($50) from the credit base which the producer would otherwise be entitled to (i.e., the $100 cost of production). Thus, the producer's credit base would equal $50 in this case.

Films Placed in Service in the Past

For the past (*i.e.*, for taxable years beginning before January 1, 1975), in general, taxpayers will come under one of two rules, either the "90-percent method," as described above, with certain modifications to deal with the foreign-use problem, or a "40-percent method," under which a taxpayer would be entitled to receive 40 percent of a full credit for all of his films, regardless of the useful life or predominant foreign use of any particular film. However, taxpayers may elect to come under the general rule for the future (the two-thirds method, as described above) for all section 50 property placed in service after the restoration of the investment credit under the Revenue Act of 1971.

Finally, certain taxpayers, who have already filed suit for a determination as to their entitlement to the investment credit for past years, may elect the application of the rules of prior law, rather than the provisions of this Act, in determining their entitlement to the credit for all past periods.

General rule for past.—Under the Act, as a general rule, the investment credit for films placed in service in taxable years beginning before January 1, 1975, is to be computed on a film-by-film basis. In determining the useful life of the film, taxpayers would use the 90-percent method as described above. However, an additional rule is necessary for the past to determine whether or not there was predominant foreign use of the film.

Under the Act, a film is to be treated as having a predominant foreign use in the first taxable year in which 50 percent or more of the gross revenues received or accrued from the film were received or accrued from showing the film outside the United States. This is a year-by-year test (not a cumulative test). For example, assume a film was released on February 1, 1972, and revenues of $100 were received that year from showing the film in the United States (with no foreign revenues), while in 1973 there were $75 of income from U.S. showings, and $25 of income from foreign exhibitions, and in 1974 there were $40 of U.S. revenues, and $60 of revenue from foreign exhibitions. In this case, there would be a predominant foreign use of the film in 1974, and as a result the film would cease to qualify as section 38 property in that year. This would mean that the taxpayer would not be entitled to an investment credit with respect to the film because the disqualifying event would have occurred less than 3 years after the property had been placed in service.[6]

Films of a transitory or topical nature would not be eligible for an investment credit.[7]

The 40-percent method.—Under the Act, the taxpayer can elect to receive 40 percent of a full credit for all of his films placed in service in taxable years beginning before January 1, 1975.[8] If the taxpayer makes this election, he is to receive the 40-percent credit, regardless of the actual useful life or predominant foreign use of any particular film. This 40-percent method is offered as a way of avoiding costly litigation with respect to past years. It is believed that this method achieves, for the average member of the film industry, about the same size credit which he would receive for all his films, on the average, were he actually to litigate.

A taxpayer is not to receive a credit for any films of a transistory or topical nature (because almost all of these films have a useful life of less than three years). Also, a taxpayer using the 40-percent method for the past is not entitled to credits for any films which were produced and shown exclusively abroad.

The election to use the 40-percent method is to be made by the taxpayer within six months after the date of enactment (October 4, 1976) in a manner to be prescribed in regulations. Any such election, once made, is to apply to all the taxpayer's films placed in service in the past (except those, if any, covered under the general rule for the future), and can be revoked only with the consent of the Internal Revenue Service.

To prevent a situation where two different taxpayers may attempt to claim the credit for the same film, the Act provides that any taxpayer making the 40-percent election must consent to join in a judicial proceeding to determine which of the competing claimants was entitled to the credit, or whether each of the parties was entitled to part of the

[6] For this limited purpose, gross foreign revenues from showing films in future years must also be taken into account. In other words, if a taxpayer uses the 90-percent method for 1974, and 50 percent or more of the revenues from showing the film in 1975 are from foreign exhibitions, this would constitute a predominant foreign use of the film placed in service in 1974, and the taxpayer would not be entitled to an investment credit with respect to that film.

[7] The Congress intends that no inference should be drawn from this report or this legislation as to what constitutes useful life, predominant foreign use, the basis on which the credit is to be computed, or any other aspect of the application of the investment credit under prior law.

[8] As described below, the taxpayer can also use this method for films placed in service on or before August 15, 1971, but elect to use the general rule for the future for all of his section 50 films.

credit.[9] The rules with respect to entitlement to the credit (i.e., the capital at risk rules, etc.) are the same for the past as for the future.

Credit base.—In general, under the Act, the rules as to the size of the credit base for the past (including those with respect to participations) are similar to the rules which are to apply for the future. However, for the past there has not been a U.S. production test in connection with movie films, and the Congress does not believe it would be appropriate to impose such a test retroactively. (The Act does impose a U.S. production test for the future, in order to encourage the U.S. production of movie films.) Thus, for the past, taxpayers may include in the credit base all the direct and indirect expenses of production, as described above, regardless of whether the film would have satisfied the 80-percent United States direct production expenses test and regardless of whether some of the expenses (actors' pay, costumes, etc.) included in the credit base were paid for services performed abroad, or for equipment and supplies which were used abroad.

The rules described above with respect to the credit base would apply both to taxpayers using the 90-percent method for the past, and to taxpayers using the 40-percent method.

Application of the general rule for the future to certain past years.—In connection with the Revenue Act of 1971 Congress made clear that it intended the investment credit to be available for movie films (whereas this question has not been completely resolved prior to that time) even though, as described above, certain subsidiary issues were not settled in that Act. For this reason, the Act provides that those taxpayers who wish to do so are to be allowed to use the general rule for the future with respect to all of their section 50 property (generally property placed in service after August 15, 1971). Thus, the Act provides that taxpayers may elect to use the general rule for the future for all of their section 50 movie films. (Taxpayers making this election could still use either the 90-percent method or the 40-percent method for all films placed in service in the past which do not qualify as section 50 property.)

Taxpayers who make this election are to be covered under the general rule for the future for all purposes, including, for example, the rules with respect to the size of the credit base, which include an 80 percent U.S. production test and exclude expenses of foreign production from the credit base.

The election to use the general rule for the future for section 50 films would have to be made within one year after the date of enactment of this Act, in a manner to be prescribed in regulations. The election would have to apply to all of the taxpayer's section 50 films, and the election, once made, could not be revoked without the consent of the Internal Revenue Service. Other rules with respect to use of this method for the past may also be prescribed by regulations.

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[9] The Congress is concerned, however, that this procedure should not unnecessarily delay the allowance of the credit in cases where it is reasonably clear that there is only one plausible person who has a right to claim the credit. The Congress intends that the Service will develop such reporting and other procedures as it deems necessary to determine whether there is a likelihood that several persons may claim a credit with respect to the same film, and that where there is no such likelihood, allowance of the credit will not be unduly delayed.

Taxpayers who have already litigated

Some taxpayers have already litigated the issues outlined above for certain prior years. The Congress believes that these taxpayers should be entitled to the fruits of their litigation because of the substantial effort and expense which they have incurred in connection with their suits. Accordingly, the Act provides that any taxpayer who has filed a petition before any court before January 1, 1976, with respect to his entitlement to the investment credit for any prior year, may elect (within 90 days after the date of enactment) to have his right to the investment credit for all taxable years beginning prior to January 1, 1975, determined under prior law, as interpreted by the courts, rather than under one of the methods prsecribed in this Act. (As an alternative, taxpayers who have filed suit prior to January 1, 1976, may elect to have their credit determined under prior law for years prior to 1971, and elect the general rule for the future for all their section 50 property.) But, of course, issues which have not already been resolved by court proceedings (such as predominant foreign use, the size of the credit base, etc.) must be settled by further litigation, and it is intended that no inference be drawn from the provisions of this Act as to how such issues should be resolved under prior law.

Generally, under this procedure, a taxpayer wishing to make an election under these provisions may do so by mailing a letter to this effect to the Commissioner of Internal Revenue within the 90-day period. Any such election is to be irrevocable.

Taxpayers relying on litigation to determine their credits for past years still must use either the general rule for the future or the 90-percent method for all taxable years beginning after December 31, 1974.

Effective dates

The effective dates of these provisions have been described above. In general, the rules with respect to the general rule for the future and the 90-percent method apply to films placed in service in taxable years beginning after December 31, 1974. In general, taxpayers may use either the 90-percent or the 40-percent method for all prior years, but may alternatively elect to use the general rule for the future for all section 50 property.

Revenue effect

It is estimated that the provisions of this section will result in a revenue cost of $37 million for fiscal year 1977, $18 million for fiscal year 1978, and $3 million for fiscal year 1981 and each year thereafter.

5. Investment Tax Credit in the Case of Certain Ships (sec. 805 of the Act and sec. 46(g) of the Code)

Prior law

The tax on income deposited into a capital construction fund (established under section 21 of the Merchant Marine Act of 1970) for the construction of certain vessels is deferred until funds are withdrawn from the fund for certain purposes. When the funds are withdrawn to purchase, construct, or reconstruct a qualified vessel, there is no tax basis in the purchased vessel to the extent of the withdrawal. Under prior law, this reduced the amount of investment credit available on the purchased vessel.

Reasons for change

The Merchant Marine Act was amended and the tax treatment accorded domestic shipping was substantially revised when the investment credit was not in effect (1970). As a result, the Congress did not at that time address itself to the question of whether the investment tax credit should be available in the case of a vessel constructed with funds withdrawn from the tax-deferred capital construction fund. In addition, since the tax provisions relating to the capital construction fund are in the Merchant Marine Act of 1936 rather than in the Internal Revenue Code, this question was not reviewed when the investment credit was subsequently restored.

The Congress believes that denying the investment credit in the case of ships built from monies taken from tax-deferred construction funds has the effect of substantially reducing the inducement to set funds aside for ship construction rather than using them for other forms of capital formation for which the investment credit is available. It is the understanding of the Congress that, in fact, the funds set aside for this purpose since the restoration of the investment credit generally have been much more limited than was previously estimated. The Congress believes it is a matter of national concern that the U.S. shipping industry have a modern fleet and be competitive in world markets. This is necessary from the standpoint of our international trading position as well as from the standpoint of having a fleet in place upon which the United States can call in times of international crisis. As a result, the Congress concluded that it was undesirable to limit the incentive of the capital construction fund by denying the full investment credit for monies withdrawn from this fund for ship construction while the investment credit is available for many other forms of capital investment.

Explanation of provisions

The Act provides for an investment credit of one-half the regular credit on the tax-deferred amounts withdrawn from the capital construction fund which are used to purchase, construct, or reconstruct qualified vessels. In addition, Congress intends that taxpayers are to have the right to obtain a court determination as to whether they are, under already existing law, also eligible for the other one-half of the regular investment credit. Also, it is intended that no inferences be drawn either way on this issue from the action taken in this Act.

If a taxpayer claims the full investment credit on its tax return, it is expected that the Internal Revenue Service will provide, by regulations, procedures which will require the taxpayer to indicate on its return that the full investment credit is being claimed. This will alert the Internal Revenue Service to the position taken by the taxpayer on this point. If the IRS asserts a deficiency in this case, the taxpayer has the option of pursuing its claim for the full credit in the Tax Court. In addition, the taxpayer may file a claim for a refund which will allow the taxpayer to pursue its claim with the Court of Claims or in the District Courts.

Where a taxpayer purchases a ship with borrowed funds and uses the capital construction fund to pay off the indebtedness, there initially will be allowed a full investment credit and then subsequently there is to be a recapture of no more than 50 percent of the amount of the investment credit taken on the purchase price of the ship representing the indebtedness which is bei g liquidated with tax deferred amounts from the capital construction fund.

Effective date

The Act applies to taxable years beginning after December 31, 1975. No inference is to be drawn from this provision regarding the application of law with respect to the availability of the credit for prior years.

Revenue effect

This provision will result in a reduction of $13 million in budget receipts in fiscal year 1977, $12 million in fiscal year 1978, and $23 million in 1981.

6. Net Operating Losses

a. Net Operating Loss Carryover Years and Carryback Election (sec. 806(a)-(d) of the Act and secs. 172, 812, and 825 of the Code)

Prior law

Prior law provided that both individual and corporate taxpayers in general were allowed to carry a business net operating loss back as a deduction against income for the three taxable years preceding the years in which loss occurred and to carry any remaining unused losses forward to the five years following the loss year (sec. 172). Under this general rule, taxpayers could balance out income and loss over a moving 9-year period. Insurance companies were also allowed 3-year carryback and 5-year carryover periods for their losses, either under the general rule (section 172) or under separate rules in subchapter L. Exceptions to the general 3-year carryback and five-year year carryover rule have been provided in the case of certain industries or categories of taxpayers. One exception allowed certain regulated transportation corporations to carry back net operating losses for the usual 3 years and to carry over such losses for 7 years.[1]

A net operating loss is required to be applied against income from other taxable years, beginning with the earliest year to which the loss may be carried. For example, if a business taxpayer, subject to the general 3-year carryback and 5-year carryover rule, had a net operating loss for 1976, the loss would be carried first to reduce or eliminate taxable income (if any) reported for 1973, and to the extent any of the loss remained unused, it would then be successively applied against any income reported for 1974 and 1975. Any of the 1976 loss unabsorbed by these three carryback years would then be used as a deduc-

[1] Another exception prohibits the carryback of a net operating loss to the extent the net operating loss was attributable to a foreign expropriation loss. However, a 10-year carryover period is allowed for the foreign expropriation loss (15 years in the case of a Cuban expropriation loss under prior law, now 20 years under section 2126 of the Act). A third exception, applicable to financial institutions for taxable years beginning after December 31, 1975, lengthens the carryback period for net operating losses to 10 years and allows the usual 5-year carryover period. Similarly, a bank for cooperatives is allowed to carry net operating losses back for 10 years and forward for 5 years. Finally, prior law also contained a provision designed for America Motors Corporation which permitted a 5 year carryback period and a carryover perior of 3 years for losses incurred for taxable years ending after December 31, 1966, and prior to January 1, 1969.

tion on the taxpayer's returns for the succeeding five years, beginning with 1977. Any loss remaining after it had been successively applied in these five years expires, and the taxpayer loses the benefit of this unused loss.

Reasons for change

Adverse economic conditions in recent years have caused many business taxpayers to incur sizable net operating losses. In many cases there is some doubt that, because of the severity of the losses and the delay in the economic recovery, these taxpayers will generate sufficient income during their existing carryover periods to enable them to use their large operating loss carryovers. In order to reduce the possibility that a similar situation will arise in the future, Congress decided to increase the loss carryover period by two additional years for taxpayers subject to the general carryback and carryover rules and for special category taxpayers with similarly short periods for absorbing operating losses.

In addition, in some cases where net operating losses have been carried back to reduce or eliminate income reported in prior years, the loss carrybacks have caused investment and foreign tax credits carried over to these prior years to expire unused because of the limited carryover periods allowed for the tax credits.

To alleviate this problem the Act provides an election for any taxpayer with a loss carryback period to relinquish the carryback period for any loss year. Because of the interaction of the net operating loss rules and other provisions of the Code, a net operating loss carryback can in some cases actually increase a taxpayer's aggregate tax liability over the 9-year carryback and carryover period. For example, if a taxpayer has a loss to be carried back and if in the carryback year the taxpayer had foreign source income which resulted in no U.S. tax liability because of foreign tax credits, the net operating loss carrybacks would merely displace the foreign source income and accompanying foreign tax credits without providing any tax benefit.[2]

Explanation of provisions

The Act makes two changes to prior law. First, the loss carryover period is increased by two years for taxpayers covered by the general rule (3-year carryback and 5-year carryover) and similarly situated taxpayers with relatively short periods to which their losses may be applied. Specifically, the two additional loss carryover years are available to taxpayers subject to the general 3-year carryback and 5-year carryover general rule, and regulated transportation corporations. In addition, the Act also extends the additional carryover years to insurance companies taxable under subchapter L of the income tax provisions (secs. 801–844), all of which had 3-year carryback and 5-year carryover periods, either under the general rule (section 172) or under separate provisions in subchapter I. As a result, these taxpayers, except for regulated transportation corporations, will have a 7-year loss carryover period. Regulated transportation corporations will have a 9-year loss carryover period. The two additional

[2] Furthermore the foreign tax credits could be carried forward only five years from the carryback year; under the Act the net operating losses could be carried forward for seven years from the current year.

carryover years are not available to taxpayers with foreign expropriation losses or to real estate investment trusts, financial institutions, or banks for cooperatives.

The second change made by these provisions of the Act concerns the net operating loss carryback period. An election is provided for any taxpayer with a loss carryback period under section 172 or under subchapter L to forego its entire carryback period for an operating loss. The election may not be made to forego only part of the carryback period for an operating loss.

The election is available for any taxable year for which there is an operating loss and must be made by the due date (including extensions of time) for filing the return for the taxable year of the operating loss. Once made, the election is irrevocable for that taxable year but has no effect on an operating loss reported for any other taxable year.

Effective date

These provisions are effective for losses incurred in taxable years ending after December 31, 1975.

Revenue effect

The provision is expected to have a negligible effect on revenues in years before 1982.

b. Special Limitations on Net Operating Loss Carryovers (sec. 806(e) of the Act and secs. 382 and 383 of the Code)

Prior law

Prior law (sec. 382(a)) provided that where new owners buy 50 percent or more of the stock of a loss corporation during a 2-year period, its loss carryovers from prior years were allowed in full if the company continued to conduct its prior trade or business or substantially the same kind of business. It could add or begin a new business, however, and apply loss carryovers incurred by the former owners against profits from the new business (unless tax avoidance was the principal purpose for the acquisition). If the same business was not continued, however, loss carryovers were completely lost. In the case of a tax-free reorganization, loss carryovers were allowed on a declining scale (sec. 382(b)). If the former owners of the loss company received 20 percent or more of the fair market value of the stock of the acquiring company, the loss carryovers were allowed in full. For each percentage point less than 20 which the former owners received, the loss carryover was reduced by 5 percentage points. It was immaterial whether the business of the loss company was continued after the reorganization (sec. 382(b)).

The former "purchase" rule of section 382(a) applied where one or more of the 10 largest shareholders increased their stock ownership, within a 2-year period, by 50 percentage points or more in a transaction in which the purchasers took a cost basis in their stock (except where the stock was acquired from "related" persons within the constructive ownership relationships described in section 318 of the Code.) The constructive ownership rules of section 318 applied, with some modifications, in determining the ownership of stock for purposes of section 382(a).

Section 382(a) also became operative if a person's stock ownership increased by at least 50 percentage points by reason of a decrease in total outstanding stock, such as occurs in a redemption of stock owned by other shareholders (except redemptions under sec. 303 to pay death taxes).

Section 383 incorporates by reference the same limitations as are contained in section 382 for carryovers of investment credits, work incentive program credits, foreign tax credits, and capital losses.

The tax law also contains a general provision which authorizes the Treasury to disallow a net operating loss carryover where any persons acquire stock control of a corporation for the principal purpose of evading or avoiding Federal income tax by obtaining a benefit which such persons would not otherwise have obtained (sec. 269 (a)(1)). A similar rule also applies to tax free acquisitions of one corporation's assets by an unrelated corporation where the acquiring company takes a carryover basis in such assets (sec. 269(a)(2)). For purposes of these rules, control means ownership of at least 50 percent of the total combined voting power of voting stock or at least 50 percent of the total value of all classes of stock.

Reasons for change

In general, the limitations contained in sections 382, 383, and 269 recognize that any rules which permit an operating loss (or other tax deductions or credits) to continue despite a substantial change in shareholders can be manipulated for tax avoidance purposes. For example, a free traffic in loss carryovers could result in large windfalls for buyers of stock or assets who could take advantage of the weak bargaining position of the existing owners of a loss business and acquire large carryovers for substantially less than their tax value. Such buyers are effectively buying a tax shelter for their expected future profits, whereas if the same persons had used their capital to start a new business on their own, no such loss offsets would be available.

On the other hand, a going business may lose money for a variety of reasons, such as bad economic conditions, competition, location, or poor business judgments by its owners. In many cases the loss can be fairly well traced to an inability or unwillingness by the existing owners to see, or to make, needed changes. In situations such as these, the owners often seek out additional co-owners to help turn the business around with fresh ideas or better management.

In several ways the former loss limitations did not deal adequately with the genuine concerns which taxpayers and the Government have in both kinds of situations described above. Generally, old section 382(a) covered stock acquisitions and section 382(b) covered asset acquisitions. These rules were not coordinated, however. They also failed to cover some transactions where "trafficking" in loss carryovers could still occur, and there were several loopholes. For example, where enough stock of a loss corporation was purchased for cash, carryovers were lost if the corporation did not continue to carry on the same kind of business it had conducted previously. However, losses could still be carried over after a taxfree reorganization whether or not the same trade or business was continued. Conversely, after a purchase of stock, losses could be carried over in full if the former business was continued even though a new profitable business could be added to absorb the existing loss carryovers; but after a reorganization, the loss carryover could be reduced even if the old business were continued.

The former purchase rules required no continuity of interest by the former owners of a loss company, since a 100 percent change in stock ownership could preserve all the carryovers if at least the same kind of business was continued. By contrast, the reorganization rules required at least 20 percent continuity by former owners if carryovers were to survive in full. Where the purchase limitations applied, the loss carryovers were completely disallowed. Where the reorganization rules applied, loss carryovers were merely reduced in proportion to the change in stock ownership.

The rule that a loss company must continue the same business when new owners buy control of its stock presented special problems. Many critics of this test argued that it is uneconomic to compel new owners of a failing business to continue to operate that business if a new activity can be found in which to make profits. Besides running counter to normal business practice, this test was also difficult to apply in specific cases, i.e., it was difficult for taxpayers and for the courts to determine at what point a change in merchandise, location or size of the business, or a change in the use of its assets, should be treated as a change in the business. The tax law has also generally permitted the continuing owners of a loss business to abandon that business entirely but still apply loss carryovers from the discontinued activity against profits from a new business.

The reorganization limitations did not apply to a "B"-type reorganization (stock for stock). This meant that a profitable company could acquire the stock of a loss company in exchange for the profit company's stock, liquidate the loss company after a reasonable interval (or transfer profitable assets into the loss company), and use its loss carryovers without limit against the future income from profitable operations. Where a profitable company used a controlled subsidiary to acquire the assets of a loss company for stock in the profitable company, the reorganization rules could also be effectively avoided because the 20 percent continuity of interest rule for the loss company's shareholders was not applied by reference to the percentage interest which these shareholders received in the profitable company (sec. 382(b)(6)).

Full preservation of loss carryovers could also be obtained under the prior rules by issuing limited preferred stock (voting or nonvoting) to the shareholders of a loss company, so long as the fair market value of the stock was at least 20 percent of the fair market value of all the acquiring company's stock immediately after the reorganization.

Congress reviewed the circumstances under which limitations should be imposed on net operating loss carryovers, whether originating with the same corporation or inherited from an acquired corporation. Congress concluded that in light of the longer carryover period permitted by this Act (sec. 806(a)), it was important to correct defects in the former rules of section 382. This meant closing loopholes and coordinating the rules for stock purchases and reorganizations so that they operate in a more equitable (and economic) manner for both taxpayers and the Government. The basic decision was to tie the survival of loss carryovers (and section 383 items) to changes in the stock ownership of a loss company, and to do so in a way that reduces the windfall to new owners who did not incur the losses but also avoids hardship to the continuing former owners (which would occur if loss carryovers were eliminated entirely).

Explanation of provisions

The Act amends sections 382 and 383 to provide more nearly parallel rules for acquisitions of stock and tax-free reorganizations involving a loss company; to eliminate the test of business continuity and base the rules solely on changes in stock ownership; and to increase the amount and kind of continuity of ownership required under these rules.

The increased ownership standard applies to the continuing interest in the loss company held by its former owners where its stock is acquired by new owners or where the loss company is the acquiring company in a reorganization. And, as under prior law, where the loss company is acquired in a reorganization, the new standard applies to the interest received by the former loss company owners in the company which acquires the loss company. The Act also increases the types of reorganizations specifically covered by sec. 382; it covers in detail reorganizations in which stock is transferred for stock ("B" reorganizations) and triangular reorganizations.

For purposes of new section 382, the continuity required of the former shareholders of a loss company is now 40 percent. For each percentage point (or fraction thereof) less than 40 but not less than 20 which the loss shareholders retain (or receive), the allowable loss carryover is reduced by 3½ percentage points. For each percentage point (or fraction thereof) less than 20, the loss carryovers are reduced by 1½ percentage points.[3]

These rules are, in general, applied by reference to the ownership by the former owners of a loss company of the lesser percentage ownership of the fair market value of the "participating stock" or of the fair market value of all the stock of the loss company (or, in the case of a reorganization, of the acquiring company if that company is not the loss company).[4] These tests mean, in effect, that carryovers can survive in full under the new rules only if a loss company's shareholders retain an interest in at least 40 percent of the continuing company's total current value *and* at least 40 percent of its future growth. This continuing interest must be retained directly in the loss company or re-

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[3] This weighted scale reflects the fact that for many tax purposes, such as tax-free liquidations under sec. 332 and the filing of consolidated returns, an acquisition of 80 percent ownership is virtually equivalent to total ownership, so that increases in ownership up to 80 percent are usually more significant than any particular ownership level above 80 percent.

[4] For example, assume that profit company P (whose total value is $600) acquires the assets of loss company L (worth $400) in a statutory merger. The combined company LP's capital structure consists of common stock worth $900 and voting preferred stock worth $100. Assuming the common stock qualifies as participating stock, L's carryovers will be preserved in full if L's former shareholders receive $400 worth of LP common stock (they will have received at least 40 percent of the value of participating stock and 40 percent of the value of all stock combined). The same result will occur if these shareholders receive $360 worth of common stock and $40 worth of voting preferred stock (this will still constitute 40 percent of the value of participating stock and a total of 40 percent of the value of all stock).

If L's shareholders receive $300 worth of common stock and $100 worth of voting preferred stock, however, they will have received 40 percent of LP's total value but only 33⅓ percent of its participating stock. Consequently, L's carryovers will be reduced by reference to the lower of these two figures, i.e., the reduction here will be 23.3 percent (6⅔ percentage point continuity below 40 times 3½ = 23.3 percentage point reduction).

tained indirectly through stock received in a company which acquires the loss company.

These tests are to be applied, as under prior law, by disregarding unissued or treasury stock, except where option attribution under section 318(a)(4) is invoked with respect to a warrant, convertible debenture, or other right to acquire stock directly from the loss company.

The new rules for both taxable and nontaxable acquisitions of a loss company apply to carryovers of operating losses incurred in the year in which an ownership change occurs and also to carryovers of earlier operating losses to that year and later years. The percentage reduction determined under the new rules is to be applied separately to each of these two categories. If, for example, the percentage reduction figure is 35 percent, carryovers to the change of ownership year are to be reduced by 35 percent and the carryover of a loss incurred in that year is also to be reduced by 35 percent.

Since section 383 incorporates the section 382 rules for capital loss, investment credit, work incentive program credit, and foreign tax credit carryovers, the Act also amends section 383 to adopt the same new rules for these items.

Purchases, etc. of stock.—The Act changes section 382(a) to focus on changes in stock ownership alone. The continuation of business rule is eliminated along with the former all-or-nothing effect of section 382(a). It will no longer be necessary to make detailed factual inquiries into the different degrees or ways that an existing business may have been changed. As a result, when a sufficient increase in stock ownership by new owners occurs, net operating loss carryovers will be limited even if the new owners continue the same trade or business. On the other hand, where carryovers are allowable under the new rules, the company may change, contract or abandon an existing business without affecting its loss carryovers.

Section 382(a) continues to measure continuity by former owners indirectly by looking to the increase in new owners' percentage ownership of a loss company's stock. However, the Act raises the point at which a specified acquisition brings the limitations into play from 50 to more than 60 percentage points. If the increase in a buyer's stock ownership is greater than 60 percentage points, the company's net operating loss carryovers are reduced by a percentage of the carryovers equal to $3\frac{1}{2}$ percentage points for each percentage point increase by the buyer above 60 and up to 80 points. If the buyer's increase is more than 80 percentage points, loss carryovers are also reduced by $1\frac{1}{2}$ percentage points for each 1 percentage point increase over 80 and up to 100.[5]

The shareholders taken into account under the new section 382(a) test to determine the increases in interest are those who hold the 15

[5] For example, if a buyer increases his stock ownership during the applicable period by 80 percentage points, the loss carryover will be reduced by 70 percent, i.e., 20 percentage points above the 60 percentage point threshold times $3\frac{1}{2}$ = a 70 percent reduction in net operating loss carryovers. This reduction will be made whether the new owners change the business or continue it.

If the buyer increases his ownership of the applicable stock of a loss company by 90 percentage points, its loss carryovers will be reduced by 85 percent, i.e., a 70 percent reduction attributable to the increase in stock ownership over 60 and up to 80 percentage points, plus another 15 percent reduction attributable to the increase in percentage points over 80 and up to 90 (10 percentage points times $1\frac{1}{2}$ = 15).

largest percentages of the total fair market value of all the stock of the company on the last day of its taxable year. ("Participating stock" is not used for this determination.) Once this group is ascertained, the percentage point increase by the group is then determined, as discussed above, by reference to the increase in percentage point ownership of the fair market value of participating stock, or of all stock, of the company, whichever increase is greater.

The relevant points for determining the extent of any ownership change as of the end of any taxable year are the beginning of the year under examination and the beginning of the first and second preceding taxable years. If one or more of these three taxable years is a short taxable year, an additional taxable year is added to the period for each such short year.

The new rules expand the list of transactions governed by section 382(a). In all cases, the increase in percentage points must be attributable to one or more of the following types of transactions:

1. A purchase of stock of a loss company from an existing shareholder or from the company itself. The term "purchase" is defined as a cost-basis acquisition.[6]

2. A purchase of stock of a corporation which owns stock in a loss company; or a purchase of an interest in a partnership or trust which owns such stock.

3. An acquisition by contribution, merger or consolidation of an interest in a partnership which owns loss company stock, or an acquisition of such stock by a partnership by means of a contribution, merger or consolidation.[7]

4. An exchange to which section 351 applies, i.e., a transfer of property to a loss company after which the transferors own 80 percent or more of the company, or an acquisition by a corporation of loss company stock in an exchange in which section 351 applies to the transferor.[8]

5. A contribution to the capital of a loss company.[9]

6. A decrease in the total outstanding stock of a loss company (or in the stock of a corporation which owns such stock). This category thus includes, but is not limited to, a redemption from other shareholders (except a section 303 redemption). In the case of a partner-

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[6] This category includes a taxable sale of profitable assets to a loss company in exchange for its stock, since the seller's basis in the stock will be his cost (fair market value) for such stock. A "failed" reorganization can thus also trigger section 382(a).

[7] To illustrate the first clause if partnership P–1, in which individuals A and B are equal partners, merges into unrelated partnership P–2, which owns loss company stock, A and B will have acquired an interest in a partnership (P–2) which owns loss company stock. To illustrate the second clause, if P–2 merged into P–1, A and B will have acquired (through P–1) a stock interest in the loss company.

[8] This category also includes an increase in percentage ownership of a loss company as a byproduct of a contribution to capital made by another person. For example, assume that unrelated individuals A and B own ⅔ and ⅓, respectively, of the sole class of outstanding stock of corporation M. Separately, B also owns 100 percent of the sole class of stock of loss company L worth $25,000. A and B then make pro rata contributions to the capital of M: A contributes $50,000 cash and B contributes all of his L stock. As a result, A will constructively own 66⅔ percent of the stock of L (by reason of his two-thirds stock ownership of M). See sec. 318(a)(2)(C). This increase in ownership of L stock by a new owner, A, requires under section 382(a) a 23⅓ percent reduction in L's loss carryovers.

[9] For example, loss company L's total value is $200. New investor N purchases all of the class A common stock worth 10 percent ($20) of L from its existing owners, who retain all of the class B common stock. N then contributes $800 of profitable assets to the company under a charter provision tying dividends to capital contributions made by the shareholders. The capital contribution, in this example, could increase N's percentage ownership of the total value of L to 82 percent ($820/$1000). If so, there would be an increase of 72 percentage points attributable to the capital contribution.

ship which owns loss company stock, liquidation by a partnership of the partnership interest of one or more partners, so as to increase the ownership interest of other partners in the partnership, is also covered.

7. Any combination of these transactions.

The above categories are also intended to cover acquisitions of an interest in a corporation, trust or partnership which does not own a loss company's stock at that time but acquires it later under a pre-existing plan.

Exceptions are made for the following acquisitions:

1. Stock acquired from a person if the stock is already attributed to the acquirer because of section 318's constructive ownership rules.[10]

2. Stock acquired by inheritance or by a decedent's estate from the decedent (regardless whether the basis is determined under section 1014 or under the carryover basis rules of section 1023); by gift; or by a trust from a grantor.

3. Stock acquired by a creditor or security holder in exchange for relinquishing or extinguishing a claim against the loss company, unless the claim was acquired for the purpose of obtaining such stock.[11]

4. Stock acquired by persons who were full-time employees of the loss company at all times during the 36-month period ending on the last day of the company's taxable year (or at at all times during its existence, if that period is shorter). This exception is not to apply, however, to an increase in the stock ownership of a person who is both an employee and has been a substantial shareholder of a loss company.

5. Employer stock acquired by a qualified pension or profit-sharing trust or by an employee stock ownership plan qualifying under Code section 4975(e)(7) or under section 301(d) of the Tax Reduction Act of 1975.[12]

6. Stock acquired in a tax-free recapitalization described in section 368(a)(1)(E).[13]

The Act brings under section 382(a) carryovers of operating losses

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[10] As under prior law, the constructive ownership rules of section 318 are incorporated by reference into section 382(a), except that corporation-to-shareholder attribution, and vice versa, operates without regard to the 50-percent threshold rule of sections 318(a)(2)(C) and 318(a)(3)(C).

This exception operates only to the extent of stock attributed to the acquiring person under section 318. Thus, for example, if shareholder A owns 20 percent of the stock (by value) of corporation M, which in turn owns all the stock of loss company L, A will be treated as owning constructively 20 percent (rather than 100 percent) of the stock of L pursuant to section 318(a)(2)(C).

As under prior law, stock acquired for the purpose of invoking this exception will be disregarded (see regulation sec. 1.382(a)-1(e)(2)).

The exception for actual transfers of loss company stock between related persons is also intended to apply if loss company stock is transferred to a newly formed corporation in the initial transfer of property to the new corporation. Such a transaction should be treated as if the transferors had first become shareholders of the holding company and then transferred to it the stock of the loss corporation.

[11] A court-supervised insolvency proceeding is not required under this exception. The exception is also intended to be available if one or more creditors transfer their claims to a new corporation in a section 351 exchange for stock in the new corporation. On the other hand, this exception does not necessarily preserve loss carryovers following a discharge in a Bankruptcy Act proceeding if, under applicable judicial authority, such a discharge *ipso facto* eliminates any losses to be carried to future years.

[12] This exception covers only the acquisition of stock of the employer company (or a parent or subsidiary of such company) by the employee-beneficiaries of the benefit plan. The trust must also benefit such employees exclusively. However, this exception is not intended to apply to collectively bargained plans or multi-employer plans within the broadened meaning of "exclusive benefit" in sections 413(b)(3) and (c)(2) of the Code.

[13] This exception may not apply to a recapitalization and acquisition which together result in increased ownership by outside investors. The Service may examine such a recapitalization and, if appropriate in the situation, treat it as part of a step transaction which is subject to the rules of section 382 without regard to this exception. This exception will also not apply if an outsider acquires stock for purposes of participating in a recapitalization.

from earlier taxable years to the taxable year at the end of which an over-60 percentage point increase in stock ownership has occurred, and also carryovers of an operating loss incurred in the latter year itself. However, the Act also adopts a "minimum ownership" rule (sec. 382(a)(3)), under which an operating loss incurred in the latter acquisition year can be carried over in full to later years if the persons who increased their ownership by over 60 percentage points owned at least 40 percent of the fair market value of the participating stock, and of all the stock, of the loss company during the entire last half of the acquisition year.[14]

If the company's stock ownership changes again before losses being carried over under the minimum ownership rule have expired, the further change in ownership must be separately tested under section 382. As a result, losses being carried forward from a minimum ownership year may be reduced as further carryovers by reason of the later transaction. The minimum ownership rule is also available with respect to an operating loss incurred in the first or second taxable year preceding the acquisition year (these are other years in the "lookback period" from the end of the taxable year being tested under section 382(a)). However, this rule does not prevent a reduction in loss carryovers from earlier years to a year when the minimum ownership rule is satisfied.[15]

Operating losses of a corporation incurred in its first taxable year are also excepted from the carryover limitations of sec. 382(a). This exception will permit the organizers of a corporation to take in additional investors during the course of its first year without adversely affecting the carryover of an operating loss incurred in that first year of the new venture.

The Act contains a successive application rule (sec. 382(a)(6)), providing that if a loss carryover has been once reduced under section 382(a), and if the new owners do not increase their interest further during the following two years, the same carryover will not be reduced again under section 382(a) at the end of either later year.[16] On the other hand, if the persons whose increase in ownership

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[14] Since the general rule of section 382(a)(1) is triggered by shareholders whose stock ownership of a loss company increases, and the minimum ownership rule operates as a limited exception to the general rule, the minimum ownership rule is itself triggered only by those among the 15 largest shareholders whose increase in ownership would otherwise bring the general rule into effect. For example, assume that individual A owns 100 percent of the sole class of stock of a calendar year loss company during all of 1980. On January 2, 1981, A sells 99 percent of his stock to unrelated individual B. In this case the company's loss carryovers to 1981 will be reduced by 97½ percent. The reason is that B is the only shareholder in the group of 15 whose stock ownership increased during the three year period ending on December 31, 1981 and B did not have a 40 percent minimum ownership during the last half of 1980. The minimum ownership rule would, however, allow aan operating loss suffered in 1981 to be carried over in full to later years since B did own at least 40 percent of the loss company's stock during at least all of the last half of 1981.

[15] For example, assume that an outside investor buys 40 percent of a loss company's stock during the first half of 1980 and then buys an additional 25 percent at any time during 1981. At the end of 1981, loss carryovers to 1981 from before 1980 will be scaled down by 17½ percent. However, the minimum ownership rule will permit a loss incurred in 1981 to carry over in full to 1982 and later years. The same rule also permits an operating loss incurred in 1980 to carry over in full to 1981 and later years because the new owner will have owned a minimum 40 percent interest during all of the last half of 1980.

[16] To illustrate, assume that an outside investor buys 65 percent of the sole class of a calendar year loss company's stock in March, 1980, and "stands still" for the next two years. At the end of 1980, loss carryovers to 1980 will be reduced by 17½ percent. (A loss in 1980 could carry over in full, however, under the minimum ownership rule.) At the end of 1981 and 1982, however, section 382(a)(1) would literally require more reductions in the unused balance of the same carryovers to those later years because a 65 percentage point increase in stock ownership would have occurred during the lookback period from each of those later years. The successive application rule prevents such further reductions.

caused a reduction in carryovers (or other persons collaborating with them under a concerted plan) buy additional stock during the first or second succeeding years, a further reduction in the unused carryovers should be made, based on the total increase in ownership by the new owners during the three-year period. In order to deal with this situation, the Service is authorized to provide regulations dealing with the computation of the further reduction in carryovers.[17]

Mergers and other tax-free reorganizations.—Where a profit company acquires the stock or assets of a loss company (or vice versa) in a taxfree reorganization, section 382(b) measures continuity by the loss shareholders' collective percentage ownership of stock of the acquiring company as the result of the reorganization. As already indictated, the new continuity test for full survival of loss carryovers is 40 percent, with a reduction of 3½ percentage points in the allowable carryover for each percentage point of continuing stock ownership less than 40 and down to 20, plus a reduction of 1½ percentage points for each percentage point of continuing stock ownership less than 20. As discussed above, these percentage tests are applied separately to the ownership (by fair market value) of the participating stock and of all stock, respectively, of the acquiring company, and the carryovers are reduced by reference to the lower continuity figure.

As under prior law, section 382(b) continues to apply to statutory mergers or consolidations and to C, D and F reorganizations (sec. 368(a)(1)(C), (D), (F), except spinoffs under section 355.[18] The Act also brings under these rules stock acquisitions solely for voting stock, as described in section 368(a)(1)(B). The rules of section 382(b) test the above reorganizations both where a loss company is the acquired or the acquiring (or surviving) company.[19]

The new limitations apply both to operating loss carryovers from taxable years of the loss company preceding its taxable year in which a reorganization occurs, and to carryovers of losses incurred in the acquisition year itself. However, a minimum ownership rule allows an operating loss incurred in the acquisition year to be carried over in full if the other party to the reorganization owned at least 40 percent of the fair market value of both participating stock and all stock of the loss company at all times during the last half of the acquisition year

[17] The Service is also authorized to prescribe rules relating to cases where a shareholder whose acquisition of stock caused a reduction in carryovers sells his stock to other new investors before the reduced carryovers are fully used or expire. It may be unfair, under some circumstances, to reduce again the carryovers which have already been reduced.

[18] The inclusion of F reorganizations is not intended to affect the question of whether an F reorganization can occur where two or more corporations are combined or, if so, whether an F reorganization can occur if complete identity of ownership does not exist (see Rev. Rul. 75–561, 1975–2 C.B. 129).

As under prior law, a purchase of stock followed by a liquidation under conditions which give the buyer an asset basis determined under section 334(b)(2) does not allow carryovers to the buyer (sec. 381(a)(1)). A liquidation of a less than wholly-owned loss subsidiary by a controlling parent corporation, in the form of an "upstream" statutory merger, must also be tested under section 382(b). Even though the parent's tax treatment will ordinarily be governed by section 332, the transaction will ordinarily be tested (as under prior law) as a reorganization as to the subsidiary's minority shareholders. The availability of the loss carryovers to the parent will then depend on the tests of section 382(b). These tests will come into play because, for purposes of section 382(b)(1), the transaction in this example will be a reorganization "described in" section 368(a)(1)(A).

[19] In the case of a C reorganization where the loss company does not distribute the stock it receives, the loss company's shareholders are treated as owning constructively the undistributed stock of the acquiring company in proportion to the value of their stock interest in the loss company (sec. 382(b)(4)(C)).

(sec. 382(b)(6)(B)). This rule may thus apply to a "creeping" acquisition where the other party to the reorganization (the acquiring or acquired company, as the case may be) previously acquired stock in the loss company.[20]

A separate rule covers a situation where a holding company (or an operating company) which controls a loss company merges or otherwise reorganizes with a profit company (regardless which company acquires the other). The Act requires, in effect, that the stock which the holding company's shareholders receive (or retain) will determine how much of the actual loss company's carryovers survive the reorganization (sec. 382(b)(3)(A)).[21]

The Act revises the prior ownership rule of former section 382(b)(5) without, however, intending any substantive change. This rule dealt with the situation where, before a merger or C reorganization, the other party to the reorganization (typically a profit company) already owned stock in the loss company. In this situation, whether the profit company acquires the loss company or vice versa, the profit company's stock interest is converted into direct ownership of an equivalent portion of the loss company's assets and ceases to be a stock interest in the loss company. For this situation, the former rule deemed the preexisting stock interest to remain outstanding after the exchange in order to give proper "credit" to the former owners of the loss company toward satisfying continuity of interest. The Act reaches the same result more simply by adding to the stock actually received by the former shareholders of the loss company constructive ownership of an additional amount of the value of the surviving company's stock equal to the value of the preexisting stock interest in the loss company which was extinguished in the reorganization (sec. 382(b)(4)(B)).[22]

The prior ownership rule does not apply to an acquisition of a loss company's assets in a C reorganization where the loss company does not distribute some or all of the stock it receives. (See footnote 17.) The prior ownership rule also does not apply to a B reorganization, for which special rules are provided (see below).

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[20] The minimum ownership rule is not intended to apply where the actual loss company is a third entity other than the acquired or acquiring company. The minimum ownership rule excepts a loss carryover unless and until another change in ownership of the loss company occurs. At any such later time, the rules of section 382 may require a further reduction in the continued carryover of any remaining balance of the carryovers.

[21] In order for this rule to apply, the company with an operating loss carryover must be a corporation other than the actual acquired or acquiring company. This rule therefore does not apply to a statutory merger of a parent company with an 80 percent or greater controlled subsidiary regardless which company in fact has loss carryovers and regardless which company is the acquiring company.

The minimum ownership rule of sec. 382(b)(6)(B) is intended to apply only where the company which increases its ownership of the loss company owned the required minimum interest in the loss company before the reorganization. For example, assume that corporation HC owns 100 percent of the one class of stock of loss company L throughout calendar 1980 and, in 1981, unrelated company P acquires HC's stock in a "B" reorganization. L suffers an operating loss in 1980. The minimum ownership rule does not apply to permit L's 1980 loss to carry over in full after the exchange.

[22] For example, assume that P, a profit company, owns 20 percent (worth $10,000) of the one class of loss company L's stock whose total value is $50,000 and that unrelated persons own the remaining $40,000 in value of L's stock. The fair market value of P's one class of stock is $100,000. If P acquires L's assets by merger, the combined asset value after the merger will be $140,000 ($10,000 of P's value is extinguished in the combination). L's former shareholders, other than P, will actually receive stock worth $40,000 in the combined entity. Under the revised credit rule, the same group of former L shareholders will also own constructively an additional $10,000 in value of the surviving company. The total combined value, $50,000, will represent a 35.7 percent equity ownership of the combined company (the same result reached by the former rule). This percentage, in turn, will require a 15.05 percent reduction in L's loss carryovers under the general rules of section 382(b) (4.3 percentage point continuity below 40 times 3½ = 15.05 percent reduction).

In order to discourage the owners of a profit company from artificially satisfying the continuity rules by buying stock in a loss company and then merging with it within a short period of time, a three-year rule disqualifies certain owners of a loss company from being included in the continuity test of section 382(b)(1) (sec. 382(b)(4)(A)). This rule applies to stock acquired in the loss company within 36 months before the reorganization by one or more shareholders who own more than 50 percent of the fair market value of the stock of another party to the reorganization, or by a controlled subsidiary of such other party. Any such stock must be disregarded in measuring continuity under section 382(b)(1).[23]

A similar rule applies to disregard, in computing continuity of ownership for purposes of section 382(b)(1), stock in the loss company acquired within 36 months before a reorganization by the other party to the reorganization (section 382(b)(4)(B) and (5)(B)).[24]

A liberalizing change is made in the common ownership exception of former section 382(b)(3), which preserved loss carryovers in full if the acquired and acquiring corporations were owned substantially by the same persons in the same proportions. Since constructive ownership rules did not apply under this exception, it was often difficult to combine second-tier subsidiaries within an affiliated group. The Act makes clear that the common ownership exception applies only to stock ownership, but also adds limited constructive ownership rules which permit certain controlled subsidiaries below a first tier to be combined with each other without loss of carryovers. If the acquired or acquiring company is a controlled subsidiary of a third company, the shareholders of the parent company will be considered to own the subsidiary's stock owned by the parent in proportion to the fair market value of their stock in the parent (sec. 382(b)(6)).[25]

If a loss company acquires the stock of a profit company in a "B" reorganization, the general rules of section 382(b) will apply to produce the proper results (that is, continuity of ownership will be determined by reference to the stock owned by the loss company's shareholders in their own company after the exchange). However, if a profit company acquires the stock of a loss company, the Act contains special

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[23] For example, assume that in 1979 A, an over-50 percent individual shareholder in profit company P, buys 55 percent of the sole class of stock of loss company L and that in 1980 L merges into P for 40 percent of P's sole class of stock. Since L's shareholders other than A owned 45 percent of L, their ratable share of the ownership of P after the merger is 18 percent (45 percent of 40 percent). L's carryovers will therefore be reduced by 73 percent (20 percentage points below 40 times $3\frac{1}{2}=70$ percent, plus 2 percentage points below 20 times $1\frac{1}{2}=3$ percent).

[24] These 36-month rules in sections 382(b)(4) and (5)(B) apply to purchases and other acquisitions covered by section 382(a) other than acquisitions excepted from that subsection. The minimum ownership rule of section 382(b)(6)(B) overrides these 36-month rules, but only as to the carryover of operating losses incurred in years in which the minimum ownership is satisfied.

[25] For example, if a common parent company, P, merges L, a wholly owned loss subsidiary, into S–2, a wholly owned second-tier profit subsidiary of P, the common ownership exception will apply because P will be treated as being the common owner of both L and S–2. Similarly, if P causes two second-tier subsidiaries in separate chains to be merged together, P will also be treated as the common owner of both merging companies.

The common ownership exception is intended to apply only to situations where neither the acquired nor acquiring company controls the other. Therefore, the exception will not apply to "upstream" or "downstream" mergers (or C reorganizations) of a parent company and its controlled subsidiary. The minimum ownership rule of sec. 382(b)(6)(B) may apply, however, to a downstream merger of this kind.

provisions requiring the continuity rules of section 382(b) to be applied by direct reference to the stock ownership of the loss company after the exchange. Exchanging shareholders will be treated as owning a percentage of the loss company's stock acquired by the acquiring company equal to the percentage of the latter's stock which such shareholders received in the exchange.[26] This percentage will then be combined with the percentage (if any) of the loss company's stock which its shareholders did not exchange. Where the acquiring company itself owned stock in the loss company before the exchange, such stock will also be counted toward satisfying the continuity rule (except, as discussed earlier, for stock acquired within 36 months before the exchange).

Under a special rule in prior law (former sec. 382(b)(6)), a profit company could arrange for a controlled subsidiary to acquire the assets of a loss company for stock of the parent company and a full carryover could be obtained if the fair market value of the loss company shareholders' stock in the parent equalled at least 20 percent of the fair market value of all the stock of the acquiring subsidiary. If the acquiring company were a newly created shell, this rule would almost always be satisfied, even though the loss company shareholders' stock in the parent may have been less than a 20-percent interest in the parent (and thus less than a 20-percent indirect interest in their former company).

The Act now requires that in this type of "triangular" reorganization, the continuity rules are to be applied by reference to the loss company shareholders' actual percentage ownership of participating stock and of all stock, respectively, of the parent company (sec. 382(b)(3)(B).[27] In the case of a triangular B reorganization, where a subsidiary of a profit company acquires the stock of a loss company in exchange for stock of the profit company, a special rule requires, in effect, a two-step calculation converting the loss shareholders' percentage ownership in the parent of the acquiring company into an equivalent percentage ownership of the acquiring subsidiary and then, in turn, into an indirect percentage ownership of the loss company (sec. 382(b)(5)(C)).[28]

Rules relating to stock.—The statute narrows the exception in prior

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[26] This rule excludes stock of the acquiring company which shareholders of the loss company may have owned before the exchange

[27] This new rule also applies to "forward" and "reverse" triangular reorganizations pursuant to section 368(a)(2)(D) and (E) of the Code. It applies to the situation existing immediately after the exchange and, at that point, the loss company's shareholders will own stock in a corporation which controls the loss company.

[28] To illustrate, assume that profit company P funds a new wholly owned subsidiary S with shares of P stock, which S then uses to acquire all the stock of loss company L in a tax-free B reorganization in exchange for 20 percent of the participating stock and of all the stock of P. As a result, L becomes a second-tier subsidiary of P. Under the rule stated above, L's shareholders will be deemed to own 20 percent of the equivalent stock of S. In turn, this interest will be treated as a 20-percent ownership of L, so that 30 percent of L's carryovers will survive the exchange (20 percentage point continuity below 40 times $3\frac{1}{2} = 70$ percent reduction).

If S had acqui d only 80 percent of L's stock for, say, 17 percent of P's stock, exchanging shareholders would be considered, by reason of their receipt of P stock, to own 13.6 percent of L after the exchange (17 percent of S s 80 percent ownership of L). After adding the 20 percent of L stock not exchanged, a total of 33.6 percent continuity would result, so that 77.6 percent of L's carryovers would survive the exchange (6.4 percentage point continuity below 40 times $3\frac{1}{2} = 22.4$ percent reduction).

law for nonvoting preferred stock which must be ignored for purposes of section 382. The new exception is limited to nonvoting stock which has fixed and preferred dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed paid-in capital or par value (except for a reasonable redemption premium), and is not convertible into another class of stock.

The Act also defines "participating stock" to mean stock (including common stock) which represents an interest in the corporate earnings and assets not limited to a stated amount of money or property or percentage of paid-in capital or par value, or by any similar formula. The reorganization rules will thus not be fully satisfied by giving loss company shareholders only conventional preferrred stock (whether voting or nonvoting).[29]

The new rules require the Service to determine by regulation whether a variety of instruments (however denoted) which may be difficult to classify under general definitions are to be considered stock or participating stock for purposes of this provision. For this purpose, the Service will deal by regulation with conversion and call rights, rights in earnings and assets, priorities and preferences, and similar factors (including collateral agreements and "puts" back to the issuing company) in determining whether or not a particular instrument will be treated as "stock" or as "participating stock."[30]

The Libson Shops doctrine.—In *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957), the Supreme Court, in a case decided under the 1939 Code, adopted an approach to the loss carryover area under which loss carryovers would basically follow the specific business activities which gave rise to the losses. Some uncertainty existed after this decision as to whether the business continuity approach represents a separate, nonstatutory test for determining carryovers of net operating losses. As a result of the changes made by the Act, Congress intends that the so-called *Libson Shops* test should have no application to determining net operating loss carryovers after stock purchases or reorganizations in tax years governed by the new rules. However, Congress intends that no inference should be drawn concerning the applicability or

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[29] As indicated earlier, section 382 is applied in effect by reference to the lesser percentage of participating stock or of all stock retained by former owners of a loss company. Under section 382(a), for example, if a loss company recapitalizes by freezing the bulk (e.g., 95 percent) of its current value into voting preferred stock, and the balance into common stock which the owners then sell to outsiders, the latters' purchase may cause a reduction in carryovers. Although the common (participating) stock represents only 5 percent of the company's current value, it also represents 100 percent of its future value. Since the former owners retained no share in this future value, the company's loss carryovers will be eliminated entirely.

[30] Under some circumstances, fully participating preferred stock may properly be treated as participating stock in light of the practical economic effect of its preferential right to earnings.

Under this delegation, the Service can also deal with contingent share reorganizations and with nonvoting preferred stock which obtains voting rights only if and when certain events occur (such as missing a stated number of dividends). The delegation will also permit the Service, on appropriate facts, to ignore stock held as security for a loan to the corporation (see regulation sec. 1.305–3(e), example (14)), or stock held in escrow (see *Glover Packing Co. of Texas v. U.S.*, 328 F. 2d 342 (Ct. Cl. 1964). This delegation also gives the Service specific authority under section 382 to treat convertible preferred stock or bonds, warrants and other options as equivalent to the underlying stock where appropriate to prevent manipulations of stock structures designed to circumvent the basic policies underlying section 382.

nonapplicability of the *Libson Shops* case in determining net operating loss carryovers to tax years governed by prior law.[31]

The general tax avoidance test.—Congress did not change the basic provisions of section 269 of the Code. Congress believes, however, that section 269 should not be applied to disallow net operating loss carryovers in situations where part or all of a loss carryover is permitted under the specific rules of section 382, unless a device or scheme to circumvent the purpose of the carryover restrictions appears to be present.[32] Congress also concluded that this general disallowance provision should be retained for transactions not expressly within the fixed rules of section 382. Section 269 is retained, for example, to deal with "built-in-loss" transactions, other post-acquisition losses, acquisitions expressly excepted from section 382, and other exchanges or transfers which are apparent devices to exploit continuing gaps in the technical rules for tax avoidance purposes.

Effective date

In order to allow a reasonable time for the Internal Revenue Service to issue regulations under the new rules, the Act delays the effective date of the new rules generally for one year. The new rules apply to reorganizations pursuant to plans adopted by one or more of the parties on or after January 1, 1978. A reorganization plan will be considered adopted on the date the board of directors adopts the plan or recommends its adoption to the shareholders, or on the date the shareholders approve the plan, whichever is earlier. If the new limitations affect a reorganization occurring in 1978, net operating loss carryovers to 1977 from earlier years will not be affected by the new rules, but carryovers of operating losses to 1978 and later years may be limited. A loss occurring in 1977 (or in a fiscal year ending in 1978) may also be limited as a carryover to 1978 (or to a fiscal year ending in 1979) and later years.

In the case of purchases of stock of a loss company and other acquisitions subject to new sec. 382(a), the new rules take effect for taxable years of a loss corporation beginning after June 30, 1978.

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[31] Congress does not intend the changes in section 382 to affect the "continuity of business enterprise" requirement which the courts and the Service have long established as a condition for basic nonrecognition treatment of a corporate reorganization (see sec. 1.368–1(b) of the regulations).

Congress also does not intend to deprive the Service of other weapons to attack transactions in which the benefits of loss carryovers are improperly transferred in ways other than by transfers of stock, or transactions where section 382 is otherwise satisfied (in whole or part). For example, the new rules do not affect the principles of substance over form, step transaction (see, e.g., the examples in regulations sec. 1.382(b)–1(c), corporate entity, assignment of income, or the rules of Code sections 482 or 704(b) (relating to allocations). Nor do the new rules prevent the Service, in appropriate cases, from challenging situations where a loss company pays more than fair market value for stock or assets of another company.

[32] For example, section 269 could still apply to a case where the capital structure of a company is arranged principally to avoid a "control" relationship under section 382, or where a permanent interest by former owners of a loss company is diluted for tax avoidance purposes. Thus, if a profit company buys less than all the stock of a loss company and then transfers in a short-term income asset such as certain kinds of royalties or an installment note receivable (or liquidates the loss company into a company which owns such assets), section 269 might still be invoked if the after-tax benefits to the new owner exceed the price paid for the loss company's stock and if the company remains a shell after the last payment on the receivable is received.

However, the "lookback" period under these rules may include earlier taxable years. The earliest lookback point, however, is January 1, 1978. For example, section 382(a) as amended will take effect for a calendar year corporation during calendar 1979. The first "lookback" period for a calendar year corporation under the new rules will be a transitional 24-month period from December 31, 1979, back to January 1, 1979, and then back to January 1, 1978. When the new rules become fully effective, the lookback period will cover three years, so that for a corporation whose taxable year ends on December 31, 1980, reference will be made back to the first day of that year and then back to January 1, 1979, and then to January 1, 1978.

In this example, the prior rules of section 382(a) will govern the allowance of loss carryovers of the company to its calendar years 1977 and 1978. The new rules will govern loss carryovers from 1978 and earlier years to 1979 and later years. Although the new rules will thus not actually limit carryovers in this example until 1979, the new limitations may affect loss carryovers to 1979 from earlier years, as well as carryovers from 1979 to later years. Also, changes in stock ownership occurring during 1978 will be taken into account as part of the lookback period from December 31, 1979, for purposes of testing loss carryovers to 1979 and later years. This means that changes in the stock ownership of a calendar year loss company during 1978 will be taken into account in applying former section 382(a) at the end of 1978 and also in applying new section 382(a) at the end of 1979 and 1980 as part of the lookback period from the end of each of those years.[33]

For a fiscal year corporation whose taxable year begins, for example, on July 1, the rules of prior section 382(a) will govern loss carryovers to fiscal 1977 and 1978. The new rules will govern loss carryovers to fiscal 1979, and for this purpose changes in stock ownership measured by reference back to stock ownership on July 1, 1978, and on January 1, 1978, will be taken into account.[34]

The statements above concerning the relationship between the new section 382 rules and section 269 of present law and the *Libson Shops* case are intended to operate initially with respect to the first taxable year to which carryovers are governed by the new rules of section 382.

Revenue effect

It is estimated that, when fully effective in 1978 and later years, the provision will increase budget receipts in light of the reduced off-

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[32] For a calendar year company, changes in its stock ownership during 1978 will thus be taken into account under the "old" rules in testing loss carryovers to 1978. The same ownership changes will also be taken into account under the new rules in testing carryovers to 1979 and later years. If no change in the stock ownership of a calendar year company occurs during 1978, new section 382(a) will not reduce its loss carryovers to 1979 (unless ownership changes occur in 1979). If changes in stock ownership do occur during 1978, those changes may reduce (under the new rules) a carryover of prior losses to 1979 and later years. This reduction of carryovers to 1979 and later years may occur even if the old rules (applied at the end of 1978) did not limit carryovers to 1978.

Similar principles also apply to fiscal year companies.

[34] For a fiscal year corporation whose taxable year begins before July 1, the rules of prior section 382(a) will govern loss carryovers to fiscal 1977, 1978 and 1979. The new rules will govern loss carryovers to fiscal 1980, and for this purpose changes in stock ownership measured by reference back to stock ownership on the first day of fiscal 1980 and 1979 and on January 1, 1978, will be taken into account.

set of past losses against current profits. However, the amount of the revenue increase is considered indeterminate because the amount of the reduction in the use of carryovers depends on the relative sizes of the companies involved and also because some acquisitions of loss companies by profitable companis may not be made.

7. Small Commercial Fishing Vessel Construction Reserves (sec. 807 of the Act and sec. 607 of the Merchant Marine Act)

Prior law

Under prior law, domestic shipping vessels had to weigh at least 5 net tons in order to be eligible for the capital construction fund (under which the tax on shipping income can be deferred if placed in a capital construction fund for future use in obtaining additional ships).

Reasons for change

In reviewing the operation of the capital construction fund, Congress was concerned that the 5-ton limitation discriminated unfavorably against small shipowners, especially those engaged in small scale commercial fishing. Accordingly, Congress concluded that a lower weight limitation would better achieve the general goal of revitalizing the U.S. commercial fleet.

Explanation of provision

The Act permits a commercial fishing vessel which is under 5 net tons, but not under 2 net tons, to be an eligible vessel under the capital construction fund (sec. 607 of the Merchant Marine Act, 46 U.S.C. 1177), if the vessel is constructed (or reconstructed) in the United States, is owned by a citizen of the United States, has a home port in the United States, and is operated in the commercial fisheries of the United States.

Effective date

The provision is effective upon the date of enactment (October 4, 1976).

Revenue effect

It is estimated that this provision will reduce revenues by less than $5 million a year.

H. SMALL BUSINESS PROVISIONS

1. Extension of Certain Corporate Income Tax Rate Reductions (Sec. 901 of the Act and secs. 11 and 821 of the Code)

Prior law

Prior to the 1975 Tax Reduction Act, corporate income was subject to a 22-percent normal tax and a 26-percent surtax (for a total tax rate of 48 percent). However, the first $25,000 of corporate income was exempt from the surtax. As a result, the first $25,000 of corporate income was taxed at a 22-percent rate and the income in excess of $25,000 was taxed at a 48-percent rate.

In the Tax Reduction Act of 1975, the surtax exemption was increased to $50,000 and the normal tax was reduced to 20 percent on the initial $25,000 of taxable income. This resulted in a 20-percent rate on the first $25,000 of income, a 22-percent rate on the next $25,000 of income, and a 48-percent rate on income in excess of $50,000. These changes were extended by the Revenue Adjustment Act of 1975 through June 30, 1976.

Reasons for change

The temporary changes in the corporate surtax exemption provided by the 1975 Tax Reduction Act were adopted for two reasons: First, to grant tax relief to small businesses which are not likely to derive substantial benefits from the liberalizations in the investment credit because they are not capital intensive; and second, to provide temporary tax relief to small business as part of a program of tax reduction designed to help sustain the economy and promote economic recovery. These reasons for increasing the surtax exemption and lowering the normal corporate tax rate continue to apply in the current economic situation.

The changes in the surtax exemption and the normal corporate tax rate made in the 1975 Tax Reduction Act did not apply to mutual insurance companies, because of a technical oversight [resulting from the fact that mutual insurance companies' tax rates are determined under a different section of the Code (sec. 821)].

Explanation of provision

The Act extends the increase in the surtax exemption and the reduction in the normal tax rates through December 31, 1977, and applies these changes to mutual insurance companies.

Effective date

These provisions make the changes in corporate tax rates and the increase in the surtax exemption applicable in the case of all taxable years ending after December 31, 1975 and before January 1, 1978. They are made applicable to mutual insurance companies for taxable years ending after December 31, 1974 and before January 1, 1978.

Revenue effect

This provision will reduce budget receipts by $1,676 million in fiscal year 1977 and $1,177 million in fiscal year 1978.

In accordance with the provision's objective, the larger part of the resulting tax reductions will accrue to small corporations. For example, about 63 percent of the aggregate tax reductions resulting from the liberalized surtax exemption and the decrease in the normal tax rate will accrue to corporations with incomes of less than $100,000.

2. Changes in Subchapter S Rules

a. Subchapter S Corporation Shareholder Rules (secs. 902 (a) and (c) of the Act and sec. 1371 of the Code)

Prior law

Subchapter S was enacted in 1958 in order to minimize the effect of Federal income taxes on businessmen's choices of the form of business organization in which they conduct their businesses, and to permit the 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 an election to be treated for income tax 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 gains) 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.

An election under subchapter S is made by, and requires the consent of, all shareholders. It may be terminated either voluntarily or involuntarily in certain circumstances.

In order to be eligible for subchapter S treatment, the stock ownership of the corporation must meet certain qualifications. First, it must be a corporation with only one issued and outstanding class of stock. Under prior law the corporation was required to have 10 or fewer shareholders, all of whom were individuals or estates and none of whom were trusts or nonresident aliens.[1]

For purposes of determining the number of shareholders, stock which is community property of a husband and wife (or the income from which is community property income) under the law of a community property State is treated as owned by one shareholder. Similarly, a husband and wife are treated as one shareholder where they own the stock as joint tenants, tenants in common, or tenants by the entirety.

Reasons for change

One of the most common uses of the subchapter S election has been in the situation of a family owned or controlled corporation. During the eighteen years that subchapter S has been in effect, many corporations which have been electing corporations during much of this period, and their shareholders, find that their subchapter S status is imperiled because of the 10-shareholder limitation. This often occurred

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[1] In addition to the stock ownership requirements, the corporation must be a domestic corporation and may not be a member (parent corporation) of an affiliated group of corporations eligible to file consolidated income tax returns.

where one of the original shareholders retires from the family business and transfers the stock to his children or leaves it to them in his will. The death of a spouse could also cause a problem under this rule. Although a husband and wife were treated as one shareholder, the deceased spouse's estate was considered to be a separate shareholder. Because of these difficulties and in order to maintain the viability of the subchapter S corporation for family owned businesses, Congress decided to make several changes in the subchapter S shareholder rules.

Explanation of provisions

The Act makes several changes in the stock ownership rules in the subchapter S provisions. First, the number of shareholders permitted in order for a corporation to qualify for and maintain subchapter S status is increased from 10 to 15 after the corporation has been an electing subchapter S corporation for 5 taxable years. Under this rule, an electing corporation may have no more than 10 shareholders during the first 5 years of its subchapter S status, but may increase its number of qualifying shareholders to 15 after this period. The 5-year period in this provision means 5 consecutive taxable years of the corporation.

Congress intends that once the corporation has satisfied the 5-year rule under any subchapter S election, it qualifies for the additional 5 shareholders even though this election has been terminated or revoked and it has subsequently made a new subchapter S election. This is to prevent a potential problem where an electing corporation's status is terminated or revoked after it has satisfied the 5-year rule and the number of shareholders has increased to more than 10. Under prior statutory rules, a corporation whose subchapter S status has been terminated or revoked is not eligible, without the permission of the Secretary, to make a new election for subchapter S treatment until the sixth taxable year following the last year the previous election was in effect. If the corporation were required to satisfy the 10-shareholder 5-year rule after this new election, the rule could force divestitures (or encourage sham transactions) by as many as 5 of the shareholders. Since this rule would create hardships in some situations, such as a family-owned small business, Congress believes that the 5-year rule should not be required to be satisfied in conjunction with a subsequent election where it was previously satisfied under an earlier election and the corporation had in fact more than 10 shareholders on the last day of the last taxable year covered by the previous election.

Other statutory changes relate to situations where ownership of a subchapter S corporation's stock changes as a result of the death of a shareholder. One change provides an exception to the 5-year threshold requirement to allow shareholders in excess of 10 (but in no event more than 15 total shareholders) during the 5-year period if the initial additional shareholders acquire their stock by inheritance.

In order not to restrict the transferability of the shares (during the 5-year period) by the inheriting shareholders, these shareholders may sell or otherwise transfer their shares during the 5-year period to a noninheriting shareholder without violating the 5-year requirement. However, the total number of shareholders during the 5-year period is not permitted to exceed the number of previous shareholders plus the number of inheriting shareholders. For this purpose, the term "inheritance" is given a broad definition to include the passing of property by legacy, devise or intestate succession.

Congress also decided to mitigate potential adverse effects of the shareholder rules where husband and wife are treated as one shareholder and one or both of the spouses die. The Act provides that where either husband or wife, or both, die, the estate of the deceased will be treated as one shareholder with the surviving spouse (or that spouse's estate) if husband and wife were treated as one shareholder while both were living and the stock continues to be held in the same proportions as before death.

The final change to the shareholder rules concerns the eligibility of trusts as shareholders in subchapter S corporations. Under the Act, grantor trusts and voting trusts may be shareholders in a subchapter S corporation. A grantor trust is defined as one treated as owned by the grantor under subpart E of part I of subchapter J of the income tax provisions (Code secs. 671–678). In addition, each beneficial owner of stock in a voting trust will be considered the shareholder for purposes of determining the number of shareholders. Any type of trust may also be a shareholder where it acquires stock in a subchapter S corporation pursuant to the terms of a will. However, the eligibility of trusts as subchapter S shareholders in this situation extends only for a period of 60 days beginning with the day on which the trust acquired the stock. Thereafter, the trust becomes an ineligible shareholder and retention of the stock beyond the 60-day period will cause a termination of subchapter S status.

Effective date

These provisions are effective for taxable years beginning after December 31, 1976.

Revenue effect

The revenue loss from these provisions is estimated to be negligible.

b. Distributions by Subchapter S Corporations (sec. 902(b) of the Act and sec. 1377 of the Code)

Prior law

The shareholders of a subchapter S corporation are taxed each year on the income of the corporation, regardless of whether this income is distributed currently as dividends to the shareholders. If the shareholders of a subchapter S corporation have been taxed on income of the corporation which has not been distributed to them, the corporation in a subsequent year can distribute this previously taxed income without the shareholders incurring any additional tax liability. However, before a distribution will constitute a distribution of previously taxed income, the corporation must first have distributed an amount equal to its current earnings and profits in the year of such distribution.

An earnings and profits rule applicable generally to corporations (sec. 312(m), enacted in 1969) requires that the earnings and profits of corporations, including subchapter S corporations, be computed using straight line depreciation, rather than the accelerated depreciation methods taxpayers may use for computing taxable income. Thus, under prior law, where a corporation elects an accelerated depreciation method, the earnings and profits of the corporation could be greater than its taxable income.

Reasons for change

In tax years where a subchapter S corporation claimed an accelerated depreciation deduction which exceeded the amount allowable under the straight line method, the corporation had current earnings and profits which exceeded its taxable income. If the corporation made cash distributions for that year in amounts in excess of its current taxable income (which is taxed to the shareholders, whether distributed or not), the excess distributions were considered dividend income to the stockholders to the extent that the corporation's current earnings and profits exceeded its taxable income. This occurred even though the corporation had undistributed taxable income which had previously been taxed to the shareholders. Congress decided that this unintended interplay between the subchapter S rules and section 312(m) should be changed so that a corporation can distribute previously taxed income to the extent its distributions exceed its taxable income even though, as a result of section 312(m), its current earnings and profits exceed its taxable income.

Explanation of provision

Under the Act, current year earnings and profits are to be computed without regard to section 312(m) solely for purposes of determining whether a distribution by a subchapter S corporation is considered to come from the corporation's previously taxed income or from its current earnings and profits. As a result, where the current earnings and profits of a subchapter S corporation exceed its taxable income because of section 312(m) for a year when it makes a cash distribution in excess of its taxable income, that excess will, to the extent of its undistributed previously taxed income, be considered to be a distribution of this previously taxed income. Consequently, it will not be taxable to the shareholders and will not reduce earnings and profits of the corporation. If the distribution exceeds the sum of the previously taxed income and the taxable income in the year of distribution, the excess will be considered a taxable dividend to the extent of the current and accumulated earnings and profits, in accordance with the rules generally applicable to corporations. Accordingly, any such excess distribution would be taxable as a dividend to the extent of current earnings and profits (determined with regard to section 312(m)) even though the corporation had a deficit in accumulated earnings and profits.

For example, assume a subchapter S corporation has $100 of taxable income, $120 of current earnings and profits (the $20 difference between taxable income and current earnings and profits representing the accelerated portion of depreciation which is not deducted for purposes of current earnings and profits as a result of section 312(m)), and $10 of undistributed taxable income previously taxed to shareholders in a prior year. Assume further that in such year the corporation distributes $120 to its shareholders. Under the Act, solely for purposes of determining whether the corporation has distributed previously taxed income, the corporation's current earnings and profits are considered to be $100. Accordingly, $10 of the amount distributed is treated as a distribution of previously taxed income and is received without additional tax liability by the shareholders, and $110 of the amount is treated as a distribution of current earnings and profits and is taxed to the shareholders as a dividend. The remaining $10 of undistributed current earnings and profits increases accumulated earnings and profits. The result of the above example would be the same even if the corporation had a deficit in accumulated earnings and profits.

Effective date

This amendment applies to taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

c. *Changes to Rules Concerning Termination of Subchapter S Election (sec. 902(c) of the Act and sec. 1372(e) of the Code)*

Prior law

Statutory rules provide generally that all shareholders of a corporation must consent to either an election of subchapter S status or to a voluntary revocation of this election. However, prior law provided that an election of subchapter S status would be involuntarily terminated if any new shareholder of the corporation did not affirmatively consent to the election, generally within a period of 30 days from the day he became a new shareholder. A consent for this purpose involved a formal filing with the Internal Revenue Service.

Reason for change

The requirement of a new shareholder's affirmative consent to a subchapter S election within a limited period of time could result in an inadvertent termination of the election if the new shareholder failed to file a timely consent or was not aware of the necessity of filing a consent. Congress was concerned that a termination of subchapter S status in these circumstances would cause a severe hardship not only to the new shareholder but to all shareholders of the corporation. It therefore decided to require that a new shareholder must affirmatively refuse to consent to a subchapter S election in order to terminate such an election.

Explanation of provision

Under the Act, in order for a subchapter S election to be terminated, a new shareholder must affirmatively refuse to consent to the election within 60 days from the time he acquired his stock in the corporation. In the case where a decedent's estate is the new shareholder, the 60-day period for filing an affirmative refusal will begin upon the earlier of either the day on which the executor or administrator of the estate qualifies or the last day of the corporation's taxable year during which the decedent's death occurred. The Secretary is authorized to issue regulations prescribing the manner in which an affirmative refusal is to be filed.

Effective date

These provisions are effective for tax years beginning after December 31, 1976.

Revenue effect

This provision involves a negligible revenue loss.

I. TAX TREATMENT OF FOREIGN INCOME

1. Exclusion for Income Earned Abroad (sec. 1011 of the Act and secs. 36 and 911 of the Code)

Prior law.

U.S. citizens are generally taxed by the United States on their worldwide income with the provision of a foreign tax credit for foreign taxes paid.[1] However, under prior law U.S. citizens who were working abroad could exclude from their income up to $20,000 of earned income for periods during which they were present in a foreign country for 17 out of 18 months or during the period they were *bona fide* residents of foreign countries (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.

The above exclusions did not apply to employees of the U.S. Government working abroad. However, prior law provided that certain special governmental allowances given to these employees were excluded from gross income and were not taxed by the United States (sec. 912). These allowances, which included housing, cost-of-living, education and travel allowances (established by various statutes) were exempt under the tax laws. (Allowances received by members of the armed forces were exempted under provisions of law outside of the Internal Revenue Code.) Any employee was entitled to exclude from gross income lodging furnished by the employer on the business premises if the employee was required to accept it as a condition of employment (sec. 119).

Reasons for change

The Congress believed that the exclusion for income earned abroad should be retained so that the competitive position of U.S. firms abroad is not jeopardized. Therefore, the Congress did not repeal the provision or phase it out. However, the Congress's attention had been called to the presence of unintended results under prior law. For example, compensation was excluded under section 911 even though it was not subject to tax by the foreign country where the employee was employed if the compensation was paid outside that foreign country (e.g., if the salary is sent to a bank outside of that country).

In those cases where a foreign tax was paid by the U.S. citizen, that tax was creditable directly against any U.S. tax that might otherwise exist on income above the $20,000 or $25,000 excludable limits. This combination of an exclusion of $20,000 or $25,000 of income, plus the allowance of the full foreign tax credit attributable to all income (including the excluded income) gave taxpayers who did pay tax to foreign governments in effect a double benefit, in that they could offset

[1] A foreign tax credit was not allowed under prior law to those individuals who took the standard deduction.

the foreign taxes paid on the excluded income against any U.S. tax which might be due on additional foreign income. The result was that substantially more than $20,000 of earned income could be exempted from U.S. tax if the U.S. employee paid any significant income tax to the foreign government.

In addition, compensation in excess of the excluded amount was taxed by the United States at a marginal rate that would apply to an employee who had not earned the excluded amount. The Congress felt that this treatment was inconsistent with our progressive tax system and that the marginal rate applicable to the employee having the advantage of the exclusion should take into account the excluded amount.

Explanation of provisions

The Act generally reduces the exclusion for earned income of individuals abroad to $15,000, except that the Act retains a $20,000 exclusion for employees of charitable organizations. If an individual performs services for an employer who was created or organized under the laws of the United States (or any State, including the District of Columbia) which meets the requirements of section 501(c)(3), the employee, if he otherwise meets the requirements of section 911, will be entitled to exclude earned income attributable to those services in an amount not in excess of $20,000 computed on a daily basis. An individual is not entitled to full benefits of the charitable exclusion and the $15,000 exclusion provided to other individuals. Accordingly the amount of earned income entitled to be excluded by reason of the general $15,000 exclusion may not exceed $15,000 reduced by the amount of earned income excluded by reason of the fact that it is attributable to qualified charitable services.

In addition, the Act makes three changes that deal with the amount eligible for the exclusion and the computation of tax liability for those individuals who claim the exclusion.

First, the Act provides that any individual entitled to the earned income exclusion is not to be allowed a foreign tax credit with respect to foreign taxes allocable to the amounts that are excluded from gross income under the earned income exclusion. Thus, foreign income taxes that are paid on excluded amounts are not to be creditable or deductible.

Second, the Act provides that any additional income derived by individuals beyond the income eligible for the earned income exclusion is subject to U.S. tax at the higher rate brackets which would apply if the excluded earned income were not so excluded. For the purpose of determining the rate brackets applicable to the nonexcluded income, the taxpayer is entitled to subtract those deductions which would be otherwise disallowed by reason of being allocable to the excluded earned income. Thus, for example, if a taxpayer has $15,000 of gross income which is excluded under the earned income exclusion and also has $5,000 of deductions which are not allowable by reason of the deductions being allocable to the excluded earned income, the taxpayer is treated as having an additional $10,000 of taxable income for purposes of computing the tax rates on the nonexcluded income.

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Since earned income is now subject to an exclusion with the other income being taxed at the higher brackets, any foreign tax credits disallowed by reason of being allocable to the excluded earned income are to be considered as those taxes paid on the first $15,000 of excluded income. Foreign taxes are allocable to the amount excluded in the proportion that the tax on net excluded earned income bears to the tax on the net taxable income. Thus, the foreign taxes allocable to the excluded amount and disallowed are those foreign taxes imposed on the first $15,000 (or other excluded amount) of income assuming a foreign effective tax rate as progressive as the U.S. tax rate.[2]

Third, the Act makes ineligble for the exclusion any income earned abroad which is received outside the country in which earned if one of the purposes of receiving such income outside of the country is to avoid tax in that country. The tax avoidance purpose does not have to be the only purpose for receiving the money outside of the country in which earned, nor does it have to be the principal reason for receiving the money outside of that country. It is sufficient that it be one of the purposes. It is the Congress's intention that the fact that the country in which the income is earned does not tax amounts received outside of the country be viewed as a strong indication of a tax avoidance purpose.

The Act provides an election to an individual not to have the earned income exclusion apply. To prevent shifting from an exclusion to a credit system from year to year, the Act provides that once an election is made not to have the exclusion apply, it is binding for all subsequent years and may be revoked only with the consent of the Internal Revenue Service.

While the Act makes no change in the taxation of housing allowances provided to overseas employees, the Congress is aware that questions have been raised as to the entitlement to the exclusion for housing furnished to employees on the employer's premises when the employee is employed on a large construction project in a remote area. Quite often no housing other than that furnished by the employer is available. Congress expects that the Internal Revenue Service will administer the exclusion of existing law in as liberal a manner as possible given the confines and limitations of the existing provision so that as many employees as possible who are involved in construction projects in remote areas will be entitled to this exclusion.

Finally, the Act provides that individuals taking the standard deduction are to be allowed the foreign tax credit.

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[2] The impact of these modifications may be illustrated by the following example (drawn from an example presented to the Senate Committee on Finance durilng the mark-up session on the provision) of a family of four who files a joint return and whose income is all foreign source income subject to foreign tax:

(1) Gross income	$32,000
(2) Deductions	4,000
(3) Personal exemptions	3,000
(4) Net taxable income	25,000
(5) Earned income exclusion	15,000
(6) Deductions allocable to amount excluded	1,000
(7) Net excluded earned income	14,000
(8) Tax on net taxable income	6,020
(9) Tax on net excluded earned income	2,760
(10) Tax prior to foreign tax credit (No. 8 less No. 9)	3,260
(11) Foreign tax paid	3,000
(12) Foreign tax allocable to excluded amount ($3,000×2,760 divided by 6,020)	1,375
(13) Foreign tax credit (No. 11 less No. 12)	1,625
(14) U.S. tax (No. 10 less No. 13)	1,635
(15) Aggregate U.S. and foreign tax (No. 14 and No. 11)	4,635

Effective date

These provisions are effective for taxable years beginning after December 31, 1975. The rule disallowing the credit for foreign taxes allocable to excluded amounts only applies to taxes paid on income excluded in taxable years beginning after that date.

Revenue effect

This provision will increase budget receipts by $44 million in fiscal year 1977, $38 million in fiscal year 1978, and $38 million in fiscal year 1981.

2. U.S. Taxpayers Married to Nonresident Aliens (sec. 1012 of the Act and secs. 879, 891, 6013 and 6073 of the Code)

Prior law

Under prior law, a husband and wife could file a joint income tax return even though one of the spouses had no gross income or deductions. However, a joint return could not be made if either the husband or the wife at any time during the taxable year was a nonresident alien. Under prior law, nonresident aliens were generally required to file estimated tax returns by April 15 of the year in question, although they had until June 15 to file the income tax return for the previous year.

Reasons for change

As a rule, a husband and wife find it desirable to file a joint return since it generally results in a lower aggregate tax liability than if they each filed separate returns of their own income and deductions. Taxpayers are encouraged to file joint returns due to the fact that it eliminates the administrative problems of otherwise having to allocate income and deductions between married taxpayers.

The inability of a husband and wife to file a joint return where one of them is a nonresident alien has resulted in the possibility of a heavier tax burden being placed upon this group of taxpayers than other married taxpayers. For example, even though a joint return was not allowed, the spouse who filed a tax return was required to use the higher rate table for married individuals filing separately. In addition, these married individuals could not obtain the benefits of the 50-percent maximum tax on earned income because married taxpayers must file a joint return in order to obtain the benefits of that provision. There are approximately 10,000 U.S. taxpayers who are married to nonresident alien individuals.

These disadvantages under the U.S. tax laws were, however, offset by a number of tax advantages for certain of these taxpayers. First, the foreign source income attributable to the nonresident alien spouse was not subject to any U.S. taxation if not effectively connected with a United States trade or business. Second, if the taxpayers were subject to community property rules, one-half of the earned income of the taxable spouse was treated as being the income of the nonresident alien spouse and was not subject to U.S. taxation if it was from foreign sources and not effectively connected with a United States trade or business.

A second problem involved the fact that certain nonresident alien individuals who were required to file declarations of estimated income tax for a taxable year were required to file two months before the time required for filing a return of income for the previous taxable year, while domestic taxpayers could file the declaration at the time the return for the previous year was due. It is normally helpful to compute tax liability for the previous year before estimating the income tax for the current year.

Explanation of provisions

The Act allows a U.S. citizen or resident married to a nonresident alien to file a joint return provided that an election is made by both individuals to be taxed on their worldwide income. The nonresident alien is treated, in effect, as a resident of the United States for purposes of the income tax laws. A requirement of the election is that the husband and wife agree to supply all the necessary books and records and other information pertinent to the determination of tax liability; failure to do so could result in termination of the election by the Secretary.

The election applies for the taxable year for which made and for all subsequent years until terminated. However, the election does not apply in a taxable year in which neither spouse is a U.S. citizen or resident at any time during the taxable year (i.e., one of the spouses must be a resident for the full taxable year). Only individuals who are residents under the normal rules of the Code are residents for purposes of satisfying the requirement that one spouse must be a citizen or resident who would otherwise be able to file a joint return.

The election continues until terminated. Either spouse may revoke the election for any taxable year so long as the revocation is made prior to the prescribed time for the filing of the income tax return for such year. The election is terminated in the event of the death of either spouse or the legal separation of the spouses under a decree of divorce or of separate maintenance. In the event of the death of either spouse, the election will ordinarily terminate for the year of the surviving spouse following the year in which the death occurred. However, if the surviving spouse is a U.S. citizen or resident who, for years subsequent to the death of the spouse, is entitled to use the joint return rates (as provided under secs. 1(a)(2) and 2), the election will not terminate until the close of the last year for which joint return rates may be used. In the event of legal divorce or separation, the election terminates as of the beginning of the taxable year in which the divorce or separation occurs.

The Secretary may terminate an election if he determines that either spouse has failed to keep adequate tax records, to give the IRS adequate access to such records, or to supply such other information as may be reasonably necessary to ascertain the taxpayer's income tax liability for the taxable year.

If an election is terminated for any two individuals for any of the reasons stated above, neither of them will be eligible to make the election for any subsequent taxable year. For example, if a divorced individual, who had previously made the election, were to remarry, he or she would not be eligible to make the election.

The above rules apply in the case of a citizen or resident who is married to an alien individual who does not become a resident of the United States. The Act provides a special rule for a nonresident alien individual who becomes a resident of the United States at the close of the taxable year if married to a citizen or resident of the United States at the close of the year. Prior law prevented this couple from filing a joint return, since they both were not citizens or residents of the United States for the entire taxable year.

The Act provides that a nonresident alien who at the close of a taxable year is a U.S. resident and is married to a U.S. citizen or resident at the close of the year may elect with the other spouse to be eligible for the joint return provision. If both spouses were nonresident aliens at the beginning of the year, they may make the election if both become residents by the close of the year. In that case, a spouse who was a nonresident alien for the first part of the year is treated as a resident of the United States for the entire taxable year for purposes of the income tax law and thus is taxable on his worldwide income. Since this provision is a limited exception for individuals when they first become residents of the United States, the election does not apply to any subsequent taxable year, and the taxpayers are not eligible to make a second election for any such subsequent year.

The Act makes certain community property laws inapplicable for income tax purposes where the election is not made. Earned income of a spouse, other than trade or business or partnership distributive share income, is treated as the income of the spouse whose services generated such income. Trade or business and partnership distributive share income subject to community property laws will receive the same treatment as that provided under section 1402(a)(5) (defining net earnings from self-employment.) Under section 1402(a)(5)(A), trade or business income (other than that derived by a partnership) which is treated as community income is treated as the income of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case the income of the trade or business is treated as that of the wife. Under section 1402(a)(5)(B), any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership which is community income or loss is treated as the income or loss of such partner, and no part of such distributive share is attributed to the other spouse.

Community income derived from separate property of one spouse (and which is neither earned income, trade or business income, nor partnership distributive share income) is treated as the income of that spouse. All other community income is treated as provided by the applicable community property law.

In addition, the Act provides for a delay in the time for filing a declaration of estimated tax for a taxable year by certain nonresident alien individuals until the time required for filing a return of income for the prior taxable year. The Act provides that in the case of nonresident alien individuals who are not subject to wage withholding, the due date for filing the estimated tax return is not to be any earlier than the due date for the tax return.

Effective dates

The provisions of the Act pertaining to the election to be treated as residents of the United States apply to taxable years ending on and after December 31, 1975. The provisions of the Act pertaining to the tax treatment of certain community income, and to the due date for filing estimated tax returns, apply to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will decrease budget receipts $1 million in fiscal year 1977, and $5 million in 1981.

3. Income of Foreign Trusts and Transfers to Foreign Trusts and Other Foreign Entities (secs. 1013 to 1015 of the Act and secs. 643(a)(b), 668, 670, 679, 1056, 1491, 1492, 6048, and 6677 of the Code)

Prior law

Under prior law, the income of a trust was taxed basically in the same manner as the income of an individual, with limited exceptions (sec. 642). Just as nonresident alien individuals are generally taxed only on their U.S. source income other than capital gains [1] and on their income effectively connected with a U.S. trade or business (and not on their foreign source income), so any trust which could qualify as being comparable to a nonresident alien individual was generally not taxed on its foreign source income.

If a trust is taxed in a manner similar to nonresident alien individuals, it is considered (under sec. 7701(a)(31)) to be a foreign trust. The Internal Revenue Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien individual. However, Internal Revenue Service rulings and court cases indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries.[2] If an examination of these factors indicates that a trust has sufficient foreign contacts, it is deemed comparable to a nonresident alien individual and thus is a foreign trust.

Under prior law, grantors and other persons were treated as the owners of that portion of a trust (under the grantor trust rules) as to which they had certain powers or interests. The grantor trust rules which tax the income of those trusts to the grantor (see secs. 671 to 678) apply equally to foreign and domestic trusts. If a U.S. grantor establishes a foreign trust which comes within these provisions, the worldwide income attributable to him of that trust is taxed by the United States to the grantor.

If a U.S. taxpayer was a beneficiary of a foreign trust, distributions to him were taxed in basically the same manner as were distributions to a beneficiary of a domestic trust. Distributions of ordinary income received from foreign trusts which could accumulate income were subject to the same throwback rules (sec. 668) which applied to domestic trusts. Under these rules a beneficiary determined his tax on a distribution of income earned by the trust in an earlier year either under

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[1] Sec. 1041 of the Act provides an exception to the rule that nonresident alien individuals (and thus comparable trusts) are taxed on their U.S. source income. That provision exempts certain U.S. source interest of nonresident aliens from U.S. taxation.

[2] For example, see Rev. Rul. 60–181 (C.B. 1960–1, 257) and *B. W. Jones Trust* v. *Commissioner,* 46 B.T.A. 531, aff'd 132 F. 2d 914.

the "exact method" or under the alternative three-year "shortcut method." Also distributions of capital gain income from a foreign trust were treated similarly to such distributions from domestic trusts (i.e., the income was excluded from distributable net income [3] and was taxed under the special capital gains throwback rules (sec. 669)), but only if the foreign trust was created by a foreign person. If a foreign trust was created by a U.S. person, gains from the sale or exchange of capital assets were included in the distributable net income and thus were treated as received by a beneficiary proportionally with any ordinary income earned by the trust in the same year. This exception favored foreign trusts created by U.S. persons over domestic trusts because a beneficiary could receive a distribution of capital gain income, which was taxed at a lower rate, without requiring the trust first to distribute all of its ordinary income. Under prior law, any capital gains income retained its character in the hands of the beneficiary, thus being eligible for the capital gains deduction (under sec. 1202) upon the distribution of the income.

In addition to the above provisions which governed the taxation of foreign trusts, prior law imposed (sec. 1491) an excise tax of 27½ percent on certain transfers of property to foreign trusts, as well as to foreign corporations (if the transfer was a contribution to capital) and to foreign partnerships. Under prior law the excise tax was imposed on all transfers of stock or securities to such an entity by a U.S. citizen, resident, corporation, partnership or trust. The amount of the excise tax was equal to 27½ percent of the amount of the excess of the value of the stock or securities over the adjusted basis in the hands of the transferor.

Reasons for change

The rules of prior law permitted U.S. persons to establish foreign trusts so that funds could be accumulated free of U.S. tax. Further, the funds of these foreign trusts were generally invested in countries which did not tax interest and dividends paid to foreign investors, and the trusts generally were administered through countries which did not tax such entities. Thus, these trusts generally paid no income tax anywhere in the world. Although the beneficiaries were taxed (and the throwback rules were applied) upon any distributions out of these trusts, nevertheless the use of foreign trusts permitted a grantor to provide a tax-free accumulation of income while the income remained in the trust. The Congress believed that allowing this tax-free accumulation of income was inappropriate and provided an unwarranted advantage to the use of a foreign trust over the use of a domestic trust. Accordingly, the Act provides that where there is a U.S. grantor the income of a foreign trust is taxable to him if the funds are being accumulated for a U.S. beneficiary. The Act also provides for an interest charge on the amount of any tax paid by a U.S. beneficiary in cases where the income of the trust is not taxable to a U.S. grantor.

In addition, the Act has made a number of changes in the treatment of domestic trusts (see sec. 701). These changes, particularly the modification of the throwback rules and the elimination of the character of capital gains upon accumulation distributions to beneficiaries, are in-

[3] The effect of excluding capital gains from distributable net income was to treat such income as being received by a beneficiary only after all ordinary income for all years of the trust had been distributed.

tended to simplify the administration of the tax laws. Adjustments in the rules applicable to foreign trusts must be made in light of these changes in order to prevent foreign trust from receiving relatively advantageous tax treatment.

A final problem that has come to the Congress's attention relates to the effectiveness of the provision in the Internal Revenue Code providing for a 27½ percent excise tax on certain transfers to foreign entities, including foreign trusts. The excise tax was intended to prevent U.S. taxpayers from transferring appreciated property to foreign trusts or other foreign entities without payment of a capital gains tax. However, under prior law the excise tax of 27½ percent of the amount of appreciation was less than the maximum capital gains tax on individuals (which can be as high as 35 percent). Furthermore, the excise tax provision had been interpreted by some tax advisors to exclude transfers to foreign entities to the extent that the entity provides some consideration to the transferor. For example, a U.S. taxpayer could transfer appreciated stock to a trust established by him and receive in return from the trust a private annuity contract or other deferred payment obligation.[4] The Congress believes it is appropriate to tax a transfer of assets in these situations.

Explanation of provisions

The Act includes three separate sets of provisions which revise the treatment of foreign trusts. First, a foreign trust, the corpus of which is, in whole, or in part, transferred to the trust by a U.S. person and which has a U.S. beneficiary, is made subject to a new grantor trust provision. This provision generally taxes the income of such a trust to the U.S. person transferring property to the trust. Second, in the case of a foreign trust the income of which is not taxed to the grantor, the taxation of any distribution to a U.S. beneficiary is revised by changing the rules for taxing capital gains income and by adding an interest charge on accumulation distributions. Finally, the excise tax on transfers to foreign entities, such as foreign trusts, is expanded in its scope and the rate of the excise tax is increased.

Grantor trust rules.—The Act contains a new grantor trust provision under which, in general, any U.S. person transferring property to a foreign trust which has a U.S. beneficiary is treated as owner of the portion of the trust attributable to the property transferred by the U.S. person.[5] The Act specifically excludes trusts described in section 404(a)(4) (relating to employee trusts created or organized outside of the United States) from this new provision.

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[4] Since the contract is viewed as consideration for the assets transferred, section 1491 had been interpreted by some tax advisers not to apply to the transfer. Under this view, the transferor could transfer an asset to a foreign trust and cause it to be sold without payment of tax and could receive, in return, annual payments which were taxed over a number of years. (But c.f. Rev. Rul. 68-183, 1968-1 Cum. Bull. 308.) The effect of this transaction was that the transferor deferred payment of a substantial amount of tax attributable to the sale of the appreciated asset and obtained the benefit of a tax-free accumulation of the proceeds of the sale. The Congress believes that any policy in favor of permitting deferral of tax in private annuity transactions should not apply to a private annuity transaction with a foreign trust. These trusts have limited assets, so that if the transferor outlives his life expectancy the trust will often be unable to continue annuity payments, and if the transferor dies prematurely his beneficiaries receive the remaining trust assets. These facts make the transaction quite different from a conventional private annuity.

[5] This provision does not affect the definition of a foreign trust provided in sec. 7701 (a)(31) of the Internal Revenue Code since the foreign source income of a grantor trust is taxed to the owner and not the trust itself.

Any U.S. person treated under this provision as owner of a portion of a trust is taxed on the income of that portion of the trust in the same manner as an owner of a trust is taxed under the existing grantor trust rules (part IE of subchapter J of the Internal Revenue Code). If another person would be treated as owner of the same portion of the trust under the grantor trust rule (sec. 678 which applies to persons other than the grantor), that other person is not to be treated as owner of that portion of the trust for tax purposes. For purposes of determining the portion of a trust over which the U.S. grantor is treated as owner, loans to the trust by the grantor may be treated as transfers of corpus.[6]

The new grantor trust provision applies to transfers of property by any U.S. person, as that term is defined in the Internal Revenue Code (sec. 7701(a)(30)). Thus, transfers by U.S. citizens or residents, by domestic partnerships, by domestic corporations, and by estates or trusts which are not foreign estates or foreign trusts are included. However, transfers by U.S. persons which take place by reason of the death of the U.S. person are not included. For example, the income of a foreign testamentary trust created by a U.S. person is not taxed to the estate of the U.S. person. In addition, an inter vivos trust which is treated as owned by a U.S. person under this provision is not treated as owned by the estate of that person upon his death.

These rules apply only for income tax purposes. Whether the corpus of the inter vivos trust is included in the estate of the U.S. person depends on the estate tax provisions of the Code. Such provisions, as well as the gift tax provisions of the Code, are unaffected by this amendment.

The new grantor trust provision applies to transfers of property by U.S. persons whether the transfers are accomplished directly or indirectly. A transfer by a domestic or foreign entity in which a U.S. person has an interest may be regarded as an indirect transfer to the foreign trust by the U.S. person if the entity merely serves as a conduit for the transfer by the U.S. person or if the U.S. person has sufficient control over the entity to direct the transfer by the entity rather than himself.[7] Further, if a foreign trust borrows money or other property the repayment of which is guaranteed by a U.S. person, that U.S. person may be treated as having transferred to the trust the property to which the guarantee applies. For this purpose, a guarantee may consist of any understanding, formal or informal, by which payment of an obligation is assured.

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[6] For example, if a U.S. person transfers $10 to a foreign trust having U.S. beneficiaries, and also lends $90 to that trust, he may be treated as the owner of trust income attributable to $100. For this purpose, if a U.S. person makes a deposit in a bank (or a contribution to another entity) and that deposit (or contribution) is followed (or preceded) by a loan of a similar amount to a foreign trust, the U.S. person may be considered to have made the loan directly to the trust.

[7] For example, if a U.S. person transfers property to a foreign person or entity and if that person transfers that property (or its equivalent) to a foreign trust that has U.S. beneficiaries, the U.S. person transferring the property to the foreign person or entity is treated as having made a transfer to a foreign trust unless it can be shown that the transfer of property to the trust was unrelated to the U.S. person's transfer of property to the foreign person or entity. A similar rule applies to transfers (including certain deferred sales) through domestic entities or persons. For example, if a U.S. person transfers property to a domestic trust or corporation and that entity subsequently transfers the same or equivalent property to a foreign trust, the U.S. person may be treated as having made a transfer of property indirectly to a foreign trust. Moreover, transfers to a domestic trust which subsequently becomes a foreign trust may be regarded as indirect transfers to a foreign trust.

Transfers by U.S. persons are subject to the grantor trust provision regardless of whether the transfers are made without receipt of consideration from the trust or whether the transfers constitute sales or exchanges (including tax-free exchanges) of the property to the trust.

However, the Act provides an exception for transfers of property to a foreign trust pursuant to a sale or exchange of the property at its fair market value if, in the transaction, the transferor realizes and recognizes all of the gain at the time of the transfer or if the gain is taxed to the transferor as provided in section 453 (providing for installment reporting of gains under certain circumstances). If this exception applies, the transferor is not treated as owner of any portion of the trust by reason of that transfer. But the transferor is treated as an owner of the trust if gain is realized from the transaction and if the transferor reports the gain as an open transaction or as a private annuity.

A U.S. person transferring property to a foreign trust is treated as an owner of the trust only if the trust has a U.S. beneficiary. The Act provides that a trust is treated as having a U.S. beneficiary if the trust instrument includes existing U.S. persons as beneficiaries or if the trust instrument (taken together with any related written or oral agreements between the trustee and persons transferring property to the trust) gives to any person the authority to distribute income or corpus to unnamed persons generally or to any class of persons which includes U.S. persons. This authority exists, for example, if any person (whether or not adverse to the grantor) has the power to appoint U.S. beneficiaries or to amend the trust instrument in such a way as to include U.S. beneficiaries. A trustee (or other person) can have authority to distribute income or corpus to unnamed persons and can avoid being treated as having a U.S. beneficiary if terms of the trust (which cannot be amended) provide that no part of income or corpus of the trust may be paid or accumulated for the benefit of a U.S. person. Of course, the fact that a named foreign beneficiary could become a U.S. person by residency or citizenship does not cause a foreign trust to be treated as a grantor trust before the event actually occurs.

In addition, the Act provides that a trust is treated as having a U.S. beneficiary for any taxable year if, assuming the trust terminated in the taxable year, any part of the remaining income or corpus of the trust could be paid to or for the benefit of a U.S. person. The same rules that apply to determine whether a trust has a U.S. beneficiary in any year during its existence are to apply to this termination provision.[8]

The Act provides that a year-by-year determination be made of whether or not a trust has a U.S. beneficiary. If a foreign beneficiary becomes a U.S. person (and thus becomes a U.S. beneficiary), the new grantor trust provision applies to the transferor beginning with the transferor's first taxable year in which the foreign person becomes a U.S. beneficiary.[9]

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[8] For example, if any person has a power to appoint a remainder beneficiary or to amend the trust provisions to name such a beneficiary, the trust is treated as having a U.S. beneficiary. Also, if under the law applicable to the trust, distributions are required to be made to U.S. persons (notwithstanding the trust instrument), the trust is treated as having a U.S. beneficiary.

[9] For example, if a trust names X, a French citizen and resident, plus X's offspring as beneficiaries, the trust would have no U.S. beneficiaries until X's offspring or X himself became a U.S. person.

The Act provides a special rule for cases in which a foreign trust acquires a U.S. beneficiary in any taxable year and has undistributed net income (i.e., accumulated income which would be taxable to a beneficiary upon distribution) as of the close of the immediately preceding taxable year. In such a case, the transferor of property to the trust is treated as having additional income in the first taxable year in which the taxpayer is treated as an owner of a portion of the trust. The amount of the additional income is equal to the undistributed net income for all prior taxable years to the extent that such undistributed net income remains in the trust at the end of the last taxable year before the trust had a U.S. beneficiary.[10]

The Act provides attribution rules for determining whether a trust has a U.S. beneficiary. A trust having a foreign corporation as a beneficiary is treated as having a U.S. beneficiary if more than 50 percent of the total combined voting power of all classes of stock is owned or considered to be owned by U.S. shareholders under the rules for determining stock ownership of controlled foreign corporations. Similarly, if a foreign trust has a foreign partnership as a beneficiary, the trust is treated as having a U.S. beneficiary if any U.S. person is a partner (directly or indirectly) of the partnership. Finally, if a foreign trust has as a beneficiary another foreign trust or a foreign estate, the first trust is considered to have a U.S. beneficiary if the second foreign trust or the foreign estate has a U.S. beneficiary.

The Act also provides that persons subject to the grantor trust rule are to file an annual information return with the Internal Revenue Service, setting out such information as is prescribed by the Secretary. A penalty equal to 5 percent of the corpus of the trust is provided for failure to file this return.

Taxation of beneficiaries of foreign trusts.—In those cases where the income of a foreign trust is not taxed to the grantor under the grantor trust rules,[11] the Act provides for an interest charge based on the length of time during which that tax was deferred because of the trust's accumulation of income. This charge is in addition to any tax which is incurred by beneficiaries receiving distributions from foreign trusts not taxed under the grantor trust rules. The interest charge is to equal 6 percent per year times the amount of tax imposed on the beneficiary (after reduction for any taxes paid by the trust). It is not compounded.[12]

In cases where the distribution in one year consists of amounts earned in more than one year, the interest charge is calculated by averaging the years in which amounts were actually earned (even though the amount of income tax to be paid by the beneficiary is determined

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[10] For example, if a trust instrument provides that income is to accumulate until distributed to Swiss citizen X's offspring, the amount accumulated is not taxed to the transferor of the property as long as the offspring are not U.S. persons. However, if any of X's offspring becomes a U.S. person, the transferor of the property is treated as having income in the amount of the undistributed net income for all taxable years (attributable to the property transferred) remaining in the trust at the end of the last taxable year before the year in which that offspring became a U.S. beneficiary. For this purpose any power over a trust (described by secs. 671–678) held by a nonresident alien shall be ignored.

[11] For example, if the U.S. grantor of the trust has died or if the trust has a foreign grantor, the new grantor trust rules do not apply.

[12] For example, the tax on a distribution in year 8 of amounts earned in year 2 (and thus deemed to be distributed in year 2) is subject to an interest charge of 6 percent for 6 years, or a total of 36 percent of the amount of tax.

under the new five-year throwback rules provided for under sec. 701 of the Act) and computing the entire charge based on that average period.[13]

The interest charge is to be calculated on an annual basis. Amounts deemed to be distributed to a beneficiary in year 1 but actually distributed in year 2 carry one full year's interest charge, regardless of when in year 1 the amounts were earned by the trust or when in year 2 the amounts were distributed.

The total of the interest charge plus the tax incurred is limited by the amount of the distribution (not including any amounts deemed distributed as taxes paid by the trust). Thus, in no case can the interest charge plus the tax on the distribution exceed the amount actually distributed. The amount of interest paid or assessed under the provision is not deductible as interest for Federal tax purposes and may itself be subject to interest charges in cases of late payment.

The interest charge applies to distributions made in taxable years of beneficiaries beginning after December 31, 1976. Solely for purposes of the interest charge, undistributed net income existing in a foreign trust as of the beginning of the first taxable year beginning after December 31, 1976, is treated as having been earned by the trust in that taxable year. Thus, any distribution out of earnings deemed to have been distributed prior to taxable years beginning after December 31, 1976, bears an interest charge beginning with the first taxable year beginning after December 31, 1976.

Under the provisions of the Act, U.S. beneficiaries receiving distributions from foreign trusts not taxed under the grantor trust rules are subject to the new five-year throwback provisions established for beneficiaries of trusts generally (see sec. 701 of the Act). Thus, the exact throwback rules and the three-year shortcut method for taxing ordinary income, plus the capital gains throwback rules, no longer apply to distributions from foreign trusts.

In addition, the new multiple trust rules (of sec. 701 of the Act) apply equally to foreign trusts as to domestic trusts. A beneficiary receiving distributions attributable to the same taxable year from three or more trusts is not permitted to gross up his distributions by the amount of trust tax paid or to receive a tax credit for distributions from any trust beyond the first two trusts. However, the Act limits to domestic trusts the provision permitting trusts to accumulate income for unborn children or children under the age of twenty-one and to avoid the throwback rules upon later distribution of the accumulated income; the throwback rules apply to distributions from foreign trusts without regard to the age of any beneficiary.

The Act provides (in Code sec. 667(a) as amended by sec. 701 of the

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[13] For example, if amounts distributed in year 8 were earned in years 2, 3, and 4, the number of years for which interest is charged is determined first by calculating the number of years of accumulation for each year in which amounts distributed were originally earned (in this case 8—2 or 6 years for amounts earned in year 2, 8—3 or 5 years for amounts earned in year 3, and 8—4 or 4 years for amounts earned in year 4). The total of these number of years of accumulation (here 6+5+4, or 15 years) is then divided by the number of different years from which the amounts distributed were earned (3 different years). The result (5 years) is the average number of years of accumulation and is multiplied by the 6 percent interest rate to produce the total percentage of interest (30 percent) which is applied against the amount of the tax.

Act) that the character of capital gains is to be disregarded for purposes of taxing accumulation distributions to the beneficiary. Furthermore, in the case of distributions of capital gain income from foreign trusts, the provision of prior law requiring that the capital gain be allocated to income and not to corpus if the foreign trust is created by a U.S. person has been expanded to apply to all foreign trusts. The effect of ending the separate characterization of income from capital gain in the new throwback provisions and of allocating to income all capital gains in foreign trusts is to treat income from capital gains the same as ordinary income when it is distributed from a foreign trust as an accumulation distribution. No exclusion of 50 percent of net long-term capital gains is available to the beneficiary of a foreign trust upon such a distribution. However, if a foreign trust has undistributed net income at the end of the last taxable year ending before January 1, 1976, which is attributable to income from capital gains from any prior taxable year, the trust is permitted to reduce undistributed net income as of the beginning of the next taxable year by the amount of the 50 percent of long-term capital gain exclusion which would be permitted to any beneficiary upon the distribution of all undistributed net income. However, no reduction in undistributed net income is permitted for foreign trusts attributable to income from capital gains earned after the effective date of these provisions.

Excise tax on transfers to foreign entities.—The Act increases the excise tax imposed under prior law (sec. 1491) on certain transfers of property to foreign trusts, foreign corporations, and foreign partnerships from 27½ percent to 35 percent. In addition, the scope of the tax has been altered. First, the tax is to apply to transfers of all types of property rather than only to transfers of securities. Second, the tax is to apply to the amount of gain which is not recognized by the transferor at the time of the transfer.

Under prior law, it was not clear whether the provision applied to all transfers of appreciated securities regardless of whether gain is recognized. Some tax advisors have interpreted the provision to apply primarily to donative transactions. The excise tax as amended by the Act is to apply to all transfers (including tax-free exchanges) whether or not at fair market value and whether or not the transfer is made with donative intent. However, in the case of transfers to corporations, the provision is to apply only to transfers treated as paid-in surplus or as a contribution to capital. The amount against which the excise tax is applied is to be reduced by the amount of gain recognized by the transferor upon the transfer of the property. Thus, all sales and exchanges (including tax free exchanges, installment sales, and private annuity transactions), regardless of how any gain on these transactions is reported, are within the scope of the excise tax provision. But to the extent the transferor immediately recognizes gain in the transfer, the amount against which the tax is applied is reduced.

The Act adds a new section to the Code under which a taxpayer may elect (under regulations prescribed by the Secretary) to treat a transfer described above as a sale or exchange of the property transferred and to recognize as gain (but not loss) in the year of the transfer the excess of the fair market value of the property transferred over the adjusted basis (for determining gain) of the property in the hands of the transferor. Thus, to the extent that gain is recognized pursuant to the election in the year of the transfer, the transfer is not subject to the excise tax, and normal rules will apply to increase the basis to the transferee by the amount of grain received. Since the objective of section 1491 is to prevent a transfer which is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes without payment of tax, the making of an election which has as one of its principal purposes the avoidance of Federal income taxes is not permitted.

As under prior law, the excise tax does not apply if the transferor can establish to the satisfaction of the Secretary that the transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. It is contemplated that ordinary business sales or exchanges involving an unrelated foreign trust will normally be determined not to be in pursuance of a plan of tax avoidance.[14] However, where the transferor of the property is directly or indirectly related in some way to the foreign entity receiving the property, then under normal circumstances, the transfer could be one in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Such a transfer would thus normally be subject to the excise tax.

A final change in the excise tax made by the Act provides that transfers to foreign entities to which section 367 of the Code applies (dealing with reorganizations and transfers involving foreign corporations) are not to be subject to the new 35 percent excise tax. The taxation of any transfer to which section 367 applies, as that section is amended by the Act (see sec. 1042), is determined entirely by that section and the regulations and rulings of the Internal Revenue Service under that section.

Effective dates

The new grantor trust rule is to apply to transfers of property to existing foreign trusts after May 21, 1974, and to all new trusts created after May 21, 1974. However, the rule is to apply to income received in taxable years beginning after December 31, 1975.

The interest charge on distributions to beneficiaries of foreign trusts is to apply to taxable years beginning after December 31, 1976. The provision applies to income from trusts whenever created. The change in the capital gains rule for foreign trusts not created by U.S. persons is to apply to taxable years beginning after December 31, 1975.

The amendment to the excise tax on certain transfers to foreign entities is to apply to transfers of property after October 2, 1975.

Revenue effect

It is estimated that these provisions will result in an increase in budget receipts of $12 million in fiscal year 1977 and of $10 million thereafter.

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[14] For example, a sale of real estate to an unrelated real estate trust in a case where the gain from the sale is reported on the installment basis should, under normal circumstances, be considered not a transfer in pursuance of a plan of avoidance of Federal taxes and thus would not normally be subject to the 35 percent excise tax.

4. Amendments Affecting Tax Treatment of Controlled Foreign Corporations and Their Shareholders (secs. 1021 through 1024 of the Act and secs. 951, 954, 956, 958, 963, and 1248 of the Code)

Prior law

The United States imposes its income tax upon the worldwide income of any domestic corporation, whether this income is derived from sources within or from without the United States. A tax credit (subject to limits) is allowed for foreign income taxes imposed on its foreign source income.

Foreign corporations generally are taxed by the United States only to the extent they are engaged in business in the United States (and to some extent on other income derived here). As a result, the United States generally does not impose a tax on the foreign source income of a foreign corporation even though it is owned or controlled by a U.S. corporation or group of U.S. corporations (or by U.S. citizens or residents). Such a corporation is subject to tax, if at all, by the foreign country or countries in which it operates.

Generally, the foreign source income of a foreign corporation is subject to U.S. income tax only when it is actually remitted to the U.S. corporate or individual shareholders as a dividend. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. The fact that no U.S. tax is imposed in this case until (and unless) the income is distributed to the U.S. shareholders (usually corporations) is what is generally referred to as tax deferral.[1]

An exception is provided, however, to the general rule of deferral under the so-called subpart F provisions of the Code. Under these provisions income from so-called tax haven activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them before they actually receive the income in the form of a dividend.

The rules generally apply to U.S. persons owning 10 percent or more of the voting power of a foreign corporation, if more than fifty percent of the voting power in the corporation is owned by U.S. persons owning 10 percent interests.

The categories of income subject to current taxation as tax haven income are foreign personal holding company income, sales income from property purchased from, or sold to, a related person if the property is manufactured and sold for use, consumption, or disposition outside the country of the corporation's incorporation, income from services performed outside the country of the corporation's incorporation for or on behalf of any related person, and shipping income (unless reinvested in shipping assets). The statute refers to these types of income as "foreign base company income." In addition, the income derived by a controlled foreign corporation from the insurance of U.S. risks is subject to current taxation. Foreign base company income and income from the insurance of U.S. risks are collectively referred to as subpart F income.

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[1] Where it is not anticipated that the income will be brought back to the United States, for financial accounting purposes (in accounting for the income of a consolidated group consisting of one or more domestic corporations and its foreign subsidiaries) this income in effect is often shown as income exempt from U.S. tax.

Also earnings of controlled foreign corporations are taxed currently to U.S. shareholders if they are invested in U.S. property. Under prior law, U.S. property was generally defined as all tangible and intangible property located in the United States.

In addition to denying deferral on certain categories of income under subpart F, the Code treats as a repatriation of tax-deferred earnings the gain realized on the sale, exchange or redemption of stock in a controlled foreign corporation (sec. 1248). If a U.S. shareholder owns 10 percent or more of the total combined voting stock of a foreign corporation at any time during the 5-year period ending on the date of the sale or exchange (while the corporation was a controlled foreign corporation), the recognized gain is treated as a dividend to the extent of the foreign corporation's post-1962 earnings and profits attributable to the stock during the time it was held by the taxpayer and was a controlled foreign corporation. Under prior law, however, this provision did not apply to earnings and profits accumulated by a foreign corporation while it was a less-developed country corporation if the stock of that corporation was owned by the U.S. shareholders for at least 10 years before the date of the sale or exchange.

a. Investment in U.S. property

Reasons for change

As indicated above, an investment in U.S. property by a controlled foreign corporation is treated as a taxable distribution to its U.S. shareholders. The reason why this provision was adopted was the belief that the use of untaxed earnings of a controlled foreign corporation to invest in U.S. property was "substantially the equivalent of a dividend" being paid to the U.S. shareholders. Therefore, it was concluded that this should be the occasion for the imposition of a tax on those earnings to the U.S. shareholders of the controlled foreign corporation making the U.S. investment. However, prior law was very broad as to the types of property which were to be classified as U.S. investments for purposes of this rule. For example, the acquisition by the foreign corporation of stock of a domestic corporation or obligations of a U.S. person (even though unrelated to the investor) was considered an investment in U.S. property for purposes of imposing a tax on the untaxed earnings to the investor's U.S. shareholders.

The Congress believed that the scope of the provision was too broad. In its prior form it may, in fact, have had a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a controlled foreign corporation looking for a temporary investment for its working capital was, by this provision, induced to purchase foreign rather than U.S. obligations. In the Congress's view a provision which acts to encourage, rather than prevent, the accumulation of funds offshore should be altered to minimize any harmful balance of payments impact while not permitting the U.S. shareholders to use the earnings of controlled foreign corporations without payment of tax.

In the Congress's view, since the investment by a controlled foreign corporation in the stock or debt obligations of a related U.S. person or its domestic affiliates makes funds available for use by the U.S. shareholders, it constitutes an effective repatriation of earnings which should be taxed. The classification of other investments in stock or debt of domestic corporations as the equivalent of dividends is, in the Congress's view, detrimental to the promotion of investments in the United States. Accordingly, the Act provides that an investment in U.S. property does not result when the controlled foreign corporation invests in the stock or obligations of unrelated U.S. persons.

In addition, the Congress believes that the inclusion of oil-drilling rigs used on the U.S. continental shelf acted as a disincentive to explore for oil in the United States. Since these rigs are movable, they can easily be used in a foreign country. Accordingly, the Act excludes these rigs from the definition of U.S. property.

Explanation of provision

The Act adds three exceptions to the types of U.S. property the investment in which by a controlled foreign corporation results in taxation to its U.S. shareholders (see sec. 951(a)(1)(B)). It provides that the term "United States property" does not include stock or debt of a domestic corporation (unless the corporation is itself a U.S. shareholder of the controlled foreign corporation), if the U.S. shareholders of the controlled foreign corporation own or are considered to own, in the aggregate, less than 25 percent of the total combined voting power of all classes of stock of such domestic corporation which are entitled to vote. Thus, under this provision, a controlled foreign corporation cannot buy the stock of, or lend money to, any of its U.S. shareholders. In addition, a controlled foreign corporation cannot buy the stock of, or lend money to, U.S. corporations who are not U.S. shareholders of that controlled foreign corporation if those U.S. shareholders own 25 percent or more of the stock of the U.S. corporation. This 25 percent test is to be applied immediately after the investment by the controlled foreign corporation.

For purposes of determining who is a U.S. shareholder of a controlled foreign corporation, the constructive ownership rules apply (sec. 958(b)). However, the exception to those rules for certain persons other than U.S. persons (contained in sec. 958(b)(1) and (4)) do not apply. Thus, for example, stock owned by foreign persons is attributed to U.S. persons for purposes of determining whether U.S. shareholders of the controlled foreign corporation own 25 percent or more of a domestic corporation, the stock of which is acquired by the controlled foreign corporation, in determining whether there has been an investment in U.S. property. If at any time there is an investment in U.S. property, the U.S. shareholders of the controlled foreign corporation will be treated as having received a distribution under section 956 equal to the amount of the investment of the controlled foreign corporation. It is intended that if the facts indicate that the controlled foreign subsidiary facilitated a loan to, or borrowing by, a U.S. shareholder, the controlled foreign corporation is considered to have made a loan to (or acquired an obligation of) the U.S. shareholder (sec. 956(c)).

The Act also excludes from the definition of U.S. property movable drilling rigs (other than a vessel or aircraft) and other oil and gas exploration and exploitation equipment, including barges which are used for oil exploration and exploitation activities on the continental shelf of the United States. Basically, this exception includes that property which is entitled to the investment credit if used outside the United States in certain geographical areas of the Western Hemisphere (see sec. 48(a)(2)(B)(x)). For this purpose, the definition of continental shelf as used in section 638 is to be applied.

Effective dates

The amendments relating to investment in U.S. property by a controlled foreign corporation apply to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders within which, or with which, such taxable years of such foreign corporations end.

For purposes of determining the increase in investment in U.S. property for years after 1975, the cumulative amount invested in U.S. property as of the close of the last taxable year of a corporation beginning before January 1, 1976, is computed under the amendments made by this section. Consequently, in determining the increase in earnings invested in U.S. property (under sec. 951(a)(1)(B)) in years beginning after December 31, 1975, only the investment in U.S. property as defined in the Act as of the close of the last taxable year beginning before 1976 is considered.[2]

Revenue effect

It is estimated that this provision will have little or no effect on tax liabilities.

b. Exception for investments in less-developed countries

Reasons for change

As indicated above, prior law contained an exception to the rules providing for dividend treatment on the sale of stock of a subsidiary which is classified as a less-developed country corporation. The extent to which this exception provided an incentive to invest in less-developed countries is questionable. The size of the tax benefit to the U.S. investor depended on a variety of factors, such as the foreign tax rate in the country where the investment is made and in other countries, and the capital gains tax rate in the United States. Further, the relationship of the tax benefits to the investor to the benefits obtained by the developing country was erratic since the size of the tax benefit could bear no relationship to the amount of development capital invested. While these factors might have occasionally combined to encourage investment in a certain less-developed country, the Congress believes that it would be preferable to provide whatever assistance is appropriate to less-developed countries in a direct manner where the economic costs can be accurately measured.

Explanation of provision

The Act repeals the less-developed country exception which excludes earnings accumulated while a corporation was a less-developed country corporation from those earnings and profits which are subject to tax as a dividend if there is gain from the sale or exchange of stock

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[2] For example, if for the last taxable year before this Act applies a controlled foreign corporation is considered to have $100 invested in U.S. property under the law in effect prior to the amendment and $75 invested in U.S. property under the law as amended, $75 is the amount considered as invested in U.S. property for purposes of determining whether there has been an increase in investment in the following year.

in the controlled foreign corporation (sec. 1248(d)(3) of the Code). However, the exclusion is still applicable with respect to those earnings of a controlled foreign corporation which were accumulated during any taxable year beginning before January 1, 1976, while the corporation was a less-developed country corporation (as defined in sec. 902(d) as in effect prior to the enactment of this Act). The exclusion applies to pre-1976 earnings regardless of whether the U.S. shareholder owned the stock for ten years as of that date.

Effective date

The provision repealing the less-developed country exception under section 1248 applies to taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of $14 million in fiscal year 1977 and of $10 million thereafter.

c. *Exclusion from subpart F of certain earnings of insurance companies*

Reasons for change

As indicated above, one of the principal categories of tax haven income subject to current taxation is foreign personal holding company income (sec. 954(c)). This item of tax haven income consists of passive investment income such as dividends, interests, rents and royalties. Prior law provided an exception for income of a foreign insurance company from its investment of unearned premiums or reserves which are ordinary and necessary for the proper conduct of its business.

In order to write insurance and accept reinsurance premiums, foreign insurance companies may be required by the laws of various jurisdictions in which they operate to meet various solvency requirements in addition to specified capital and legal reserve requirements. Many jurisdictions also employ an internal rule-of-thumb as to what the ratio of surplus to earned premiums should be. In the United States, the National Association of Insurance Commissioners employs a ratio of 1 to 3 (surplus to earned premiums) as the guideline by which State regulatory agencies can measure the adequate solvency of companies insuring casualty risks. If such a company's ratio were less than 1 to 3, for instance 1 to 4, the State regulatory agency may question its ability to accept additional risks. Surplus maintained in compliance with the 1 to 3 ratio, although not necessarily required by law, has been considered as ordinary and necessary to the proper conduct of a casualty insurance business in the United States.

Similar ratios often are employed in some foreign jurisdictions with respect to companies insuring casualty risks. Even where the foreign jurisdiction does not impose requirements as severe as those required in the United States, a foreign insurance company participating in a reinsurance pool composed principally of companies doing business in the United States must, for all practical purposes, maintain this ratio to satisfy the State insurance authorities involved. In these situations, the State regulatory agency, employing the relatively high ratio, will review the solvency of the foreign insurer before allowing the placement of the reinsurance policy with such foreign insurer. This effectively causes any foreign insurance company participating in a reinsurance pool to adhere to the high ratio. Those assets maintained by these insurance companies in order to meet this ratio test are necessarily in the form of investments, which, in turn, generate passive income such as dividend and interest income. Just as in the case of the maintenance and investment of unearned premiums or reserves, these insurance companies, in compliance with the high ratio requirement, must maintain and invest a certain portion of their assets in connection with the active conduct of their trade or business. The Congress believes that it is appropriate to provide the same type of exception from subpart F for surplus which is required to be retained as is provided for unearned premiums or reserves.

Explanation of provision

The Act adds a new exception to the definition of foreign personal holding company income (sec. 954(c)(3)(C)). Under the exception, foreign personal holding company income does not include dividends, interest, and gains from the sale or exchange of stock or securities derived from investments made by an insurance company of an amount of assets equal to one-third of its premiums earned (as defined under sec. 832(b)(4)) during the taxable year on insurance contracts (other than for life insurance and annuity benefits under life insurance and annuity contracts, to which sec. 801 pertains).

The exception only applies to passive income received from a person other than a related person (as defined in sec. 954(d)(3)). Also, the exception only applies with respect to premiums which are not directly or indirectly attributable to the insurance or reinsurance of related persons. Where an insurance company participates in an insurance or reinsurance pool, it is not intended that the risk insured or reinsured by such company be treated as a risk of a related person merely because of the existence of the pooling arrangement, the existence of joint liability on the risk, or because a related insurance company may jointly share in the risk on a policy issued by one member of the pool.

Effective date

The provision applies to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders within which or with which the taxable years of the foreign corporations end.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of $14 million in fiscal year 1977 and of $10 million per year thereafter.

d. Shipping profits of foreign corporations

Reasons for change

As indicated above, one of the categories of tax haven income subject to current taxation under the subpart F provisions of the Code is income derived from, or in connection with, the use of an aircraft or vessel in foreign commerce, except to the extent that the profits are reinvested in shipping assets. In general, foreign base company income is defined for purposes of the tax haven provisions to mean income earned by a corporation outside the country of incorporation. In the case of foreign base company shipping income, however, no distinction was made under prior law for cases where a corporation derived its shipping income in the same country where it was incorporated. As in the case of other tax haven income, the Congress believes that shipping activities should not be categorized as a base company activity when the corporation involved carries on its activities entirely in the country in which it is organized and the aircraft or vessel is registered.

The Congress also is aware that the law is unclear as to what shipping profits are considered as reinvested in shipping assets and thus entitle a controlled foreign corporation to an exclusion from the subpart F provisions. The Congress wants to insure that in any case where a controlled foreign corporation discharges an unsecured liability which constitutes a general claim against its shipping assets, the payment in discharge of that liability should be considered a payment toward the acquisition of a shipping asset as much as the payment on an obligation which constitutes a specific charge against a shipping asset.

Explanation of provision

The Act provides that base company income does not include shipping income derived by a controlled foreign corporation from the operation (or hiring or leasing for use) of a vessel or airplane between two points in the country in which the vessel or airplane is registered and the controlled foreign corporation is incorporated. Thus, income earned by a lessee from the operation of the vessel or aircraft between two points within the country of registration qualifies for this exception if the lessee is incorporated in that country whether or not the owner of the vessel is incorporated there. Similarly, income derived by the owner from the hiring or leasing of a vessel or airplane for use between two points within the country of registration qualifies for the exception if the owner is incorporated in that country whether or not the lessee is also incorporated there.

Effective date

The changes made by the Act are applicable as of the date of the provisions which added the foreign-base company shipping rules and thus apply to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders within which or with which such taxable years of the foreign corporations end.

Revenue effect

It is estimated that this provision will decrease receipts by less than $5 million on an annual basis.

5. Amendments to the Foreign Tax Credit (secs. 1031 to 1037 of the Act and secs. 78, 901, 902, 904, 908, and 960 of the Code)

Prior law

Taxpayers subject to U.S. tax on foreign source income may take a foreign tax credit for the amount of foreign taxes paid on income from sources outside of the United States. The credit is provided only for the amount of income, war profits or excess profits taxes paid or accrued during the taxable year to any foreign country or to a possession of the United States.

This foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to insure that double taxation does not result. Some countries avoid double taxation by exempting foreign source income from tax altogether. For U.S. taxpayers, however, the foreign tax credit system, providing a dollar-for-dollar credit against U.S. tax liability for income taxes paid to a foreign country, is the mechanism by which double taxation is avoided.

The foreign tax credit is allowed not only for taxes paid on income derived from operations in a specific country or possession of the United States, but it is also allowed for dividends received from foreign corporations operating in foreign countries and paying foreign taxes. This latter credit, called the deemed-paid credit, is provided for dividends paid by foreign corporations to U.S. corporations which own at least 10 percent of the voting stock of the foreign corporation. Dividends to these U.S. corporations carry with them a proportionate amount of the foreign taxes paid by the foreign corporation.

The computation of the amount of the foreign taxes allowed as a deemed-paid credit in the case of a dividend distribution differed depending upon whether or not the payor of the dividend was a less-developed country corporation. Initially, a question arose as to how much of the foreign taxes for purposes of this credit should be attributed to the earnings out of which dividends were paid and how much should be attributed to the portion of earnings used to pay the foreign taxes. This was decided in the Supreme Court case, *American Chicle Company*,[3] which required the foreign taxes paid for purposes of the credit to be allocated between the dividend distribution and the portion of the earnings used to pay the foreign taxes. The Congress in 1962, however, recognized that this resolution obtained less than the full U.S. tax on the dividend income because it omitted from the U.S. tax base the portion of the earnings used to pay the foreign tax. Where the foreign tax was less than the U.S. tax (but above zero), this gave an advantage to dividend income over income subject to the full United States tax. In 1962, the Congress corrected this problem for all corporations other than less-developed country corporations.

The correction made in 1962 took the form of requiring the earnings used to pay the foreign tax to be included in the deemed distribution base and then allowing the credit for foreign taxes paid to be based upon the earnings, including the amount paid as foreign taxes, and not merely the portion paid as a dividend.

These rules for the deemed-paid credit apply to distributions to a domestic corporation from a first-tier foreign corporation in which the domestic corporation is a 10-percent shareholder and to distributions from a second-tier or third-tier foreign corporation (through a first-tier foreign corporation). However, distributions originating

[3] *American Chicle Company* v. *United States*, 316 U.S. 450 (1942).

from a foreign corporation that is more than three-tiers beyond the domestic corporate shareholder do not carry with them any deemed-paid foreign tax credit.

In order to prevent a taxpayer from using foreign tax credits to reduce U.S. tax liability on income from sources within the United States, two alternative limitations on the amount of foreign tax credits which could be claimed were provided by prior law. Under the overall limitation, the amount of foreign tax credits which a taxpayer can apply against his U.S. tax liability on his worldwide income is limited to his U.S. tax liability multiplied by a fraction the numerator of which is taxable income from sources outside the United States and the denominator of which is worldwide taxable income. Under this limitation, the taxpayer thus aggregates his income and taxes from all foreign countries; a taxpayer may credit taxes from any foreign country as long as the total amount of foreign taxes applied as a credit in each year does not exceed the amount of tax which the United States would impose on the taxpayer's income from all sources without the United States.

The alternative limitation was the per-country limitation. Under this limitation the same calculation made under the overall limitation was made on a country-by-country basis. The allowable credits from any single foreign country could not exceed an amount equal to U.S. tax on worldwide income multiplied by a fraction the numerator of which was the taxpayer's taxable income from that country and the denominator of which was worldwide taxable income. Taxpayers were required to use the per-country limitation unless they elected the overall limitation. Once the overall limitation was elected, it could not be revoked except with the consent of the Secretary or his delegate.

The Tax Reduction Act of 1975 prohibited the limitation on the foreign tax credit on income from oil-related activities from being calculated under the per-country method. Instead, this income (and any losses) is computed under a separate overall limitation which applies only to oil-related income. Any losses from oil-related activity are to be "recaptured" in future years through a reduction in the amount of allowable foreign tax credits which can be used to offset subsequent foreign oil-related income.

In addition, the Tax Reduction Act of 1975 requires that the amount of any taxes paid to foreign governments which will be allowed as a tax credit on foreign oil and gas extraction income be limited to 52.8 percent of that income in 1975, 50.4 percent in 1976, and 50 percent in subsequent years.

Finally, the Tax Reduction Act of 1975 requires that no tax credit at all be allowed with respect to payments to a foreign country in connection with the purchase and sale of oil or gas where the taxpayer has no economic interest in the oil or gas and the purchase or sale is at a price which differs from the fair market value.

In computing taxable income from any particular country or from all foreign countries for purposes of the fractions used in the tax credit limitations, all types of income were included under prior law as well as the deductions which related to that income and a proportionate part of deductions unrelated to any specific item of income. Thus, for example, income from capital gains was included in the numerator and denominator of the limiting fraction as well as the deductions allocable to those gains (e.g., the 50-percent exclusion of capital gains for individuals). However, an exception was provided for interest income if that income was not derived from the conduct of a banking or financing business, or was not otherwise directly related to the active conduct of a trade or business in the foreign country. Such interest income and the taxes paid on it was subject to a separate per-country limitation to be calculated without regard to the other foreign income of the taxpayer.

In cases where the applicable limitation on foreign tax credits reduces the amount of tax which can be used by the taxpayer to offset U.S. tax liability in any one year, the excess credits not used may be carried back for two years and carried forward for five years. However, if a person using the per-country limitation in any year elected subsequently to use the overall limitation, no carryovers were permitted from years in which the per-country limitation was used to years in which the overall limitation was elected.

The prior foreign tax credit system, and in particular the alternative methods of computing the limitation on allowable foreign tax credits, contained a number of problems which resulted in inequities between taxpayers and which, in some cases, resulted in a reduction of U.S. tax on U.S. source income.

a. Per-country limitation and foreign losses

Reasons for change

The use of the per-country limitation often permitted a U.S. taxpayer who had losses in a foreign country to obtain what was, in effect, a double tax benefit. Since the limitation was computed separately for each foreign country, losses in any foreign country did not have the effect of reducing the amount of credits allowed for foreign taxes paid in other foreign countries from which other income was derived. Instead, such losses reduced U.S. taxes on U.S. source income by decreasing the worldwide taxable income on which the U.S. tax was based. In addition, when the business operations in the loss country became profitable in a subsequent tax year, a credit was allowed for the taxes paid in that country. Thus, unless the foreign country in which the loss occurred had a tax rate no higher than the U.S. rate and had a net operating loss carryforward provision (or some similar method of using prior losses to reduce subsequent taxable income), the taxpayer received a second tax benefit when income was derived from that foreign country because no U.S. tax was imposed on the income from that country (to the extent of foreign taxes paid on that income) even though earlier losses from that country had reduced U.S. tax liability on U.S. source income.

The Congress does not believe that taxpayers should be permitted to obtain the double tax benefits described above. Accordingly, the per-country limitation was repealed. In addition, where a taxpayer on the overall limitation reduces U.S. tax on domestic income by means of a loss from foreign sources, the Congress believes that this tax benefit should be subject to recapture by the United States where foreign source income is subsequently derived.

(1) Per-country limitation

Explanation of provisions

The Act includes two provisions which prevent losses incurred from activities abroad from reducing U.S. tax on U.S. source income. The Act repeals the per-country limitation. Taxpayers will be required to compute the limitation of the amount of foreign tax which can be used to reduce U.S. tax under the overall limitation. The effect of this provision is that losses from any foreign country will reduce income from other foreign countries for purposes of calculating the foreign tax credit limitation, and thus will reduce the amount of foreign taxes which can be used from those countries as a credit against U.S. tax. Foreign losses will reduce U.S. tax on U.S. income only in cases where foreign losses exceed income from all foreign countries for the taxable year. The Act also provides that the separate limitation for interest income, which under prior law was computed on a country-by-country basis, is to be computed on an overall basis.

It is the Congress's understanding that the per-country limitation is not required under the provisions of any recent income tax treaty between a foreign country and the United States. It is the Congress's intent that all existing treaties are to be applied consistently with this provision by using the overall limitation in computing the allowable foreign tax credit.[4]

Because the provisions of this Act require taxpayers to compute their tax credit limitation on the overall method, special rules are included for taxpayers previously on the per-country limitation to permit some excess credits to be carried over from years in which the per-country limitation applied to years in which the overall limitation applies; similarly, special rules are provided to permit carrybacks from overall years to per-country years. The Congress recognizes that the repeal of the per-country limitation may have a substantial adverse impact on the consolidated tax liability of an affiliated group. It is anticipated that in these cases the Internal Revenue Service will permit these companies to discontinue filing consolidated returns.

Carryovers from years beginning before January 1, 1976, during which the taxpayer was on the per-country limitation, to years beginning after December 31, 1975 (i.e., years during which the taxpayer is required to be on the overall limitation) are permitted if such carryovers were created under the rules of prior law (i.e., if, under the per-country limitation, the taxpayer had excess credits from one or more countries which could be carried forward). Under the Act these excess credits are further limited in that they may be used only to the extent they would be used had the per-country limitation continued to apply in the succeeding taxable years. This computation is to be made in the following steps. If the excess credits attributable to any specific country from prior years could have been used under the per-country limitation in the current year, the use of these credits in the current year is further restricted if the overall limitation produces a lower amount of total credits. If this limitation applies, the amount

[4] The Congress further intends that, as is the case with other recent legislation modifying the foreign tax credit, the changes made by the Act are to be used in computing the credit allowed under all treaties.

of the carryovers which may be used as credits are reduced to the amount allowed under the overall limitation. The amount of credits attributable to any country which are treated as being used in the current year is to be reduced by the amount of credits allowed under the per-country limitation that are not allowed under the overall limitation. This reduction in the credits to be available is allocated among the credits attributable to each of the foreign countries in the ratio of the credits allowable under the per-country limitation for each country to the aggregate of the credits allowable on this basis for all countries.[5] The remaining credits from each country which cannot be used in the current year can continue to be carried forward until the end of the 5-year carryforward period.

A slightly different rule is provided for foreign taxes which arise in taxable years beginning after December 31, 1975 (overall limitation years), which may be carried back to years beginning before January 1, 1976, during which the taxpayer was on the per-country limitation. First, the taxpayer is to determine if, under the normal rules applying to the overall limitation, any excess credits arise in the current year which are available to be carried back. If such excess credits do arise, the taxpayer is to make a country-by-country computation for the current year to determine what, if any, excess credits would arise from each country in that year under the per-country limitation. If excess credits arise from any country, those credits can be carried back. The credits which are available to be carried back for each country can then be applied to the appropriate earlier years if these excess credits could have been used in those years under the per-country limitation. Credits which are not available to be carried back may be carried forward to subsequent years under the 5-year carryforward rules.

Effective date

The repeal of the per-country provision and the related carryback and carryover rules apply to taxable years beginning after December 31, 1975.

The Congress is aware of the fact that certain existing mining ventures were begun with substantial investments of capital under the assumption that the foreign tax credit could be computed under the per-country limitation. The Congress believes that it is appropriate to provide a limited transitional rule for these cases. The Act provides that in the case of a domestic corporation (whether or not it joins in the filing of a consolidated return with other corporations) which as

[5] The following example illustrates this reduction. Assume company X has operations in countries A, B, and C as follows:

	A	B	C	Total
Income	40	60	−40	60
Taxes (current plus carried forward)	25	30	0	55

With a 50-percent U.S. tax rate, company X could use 50 credits under the per-country limitation (20 in A and 30 in B) and 30 under the overall. Thus the amount of the reduction is 20 (50 minus 30), and is allocated 8 to country A (20/50×20) and 12 to country B (30/50×20). In this case, 13 credits will be carried forward to subsequent years from country A (5 originally disallowed by the per-country limitation, plus 8 disallowed under the overall) and 12 credits will be carried forward from country B.

of October 1, 1975, has satisfied four conditions, the per-country limitation may be used for all taxable years beginning before January 1, 1979. The four conditions are that the corporation has as of October 1, 1975: (1) been engaged in the active conduct of the mining of hard minerals (of a character for which a percentage depletion deduction is allowable (under sec. 613)) outside the United States or its possessions for less than 5 years; (2) has had losses from the mining activity in at least 2 of the 5 years; (3) derived 80 percent of its gross receipts since the date of its incorporation from the sale of the minerals that it mined; and (4) made commitments for substantial expansion of its mining activities.

A commitment for substantial expansion of mining activities means a commitment of additional capital for the purpose of substantially expanding mining production. For example, if the production of a mine for the period immediately before October 1, 1975, averaged less than 75 percent of designed capacity and if additional capital is required in order to increase production to reach designed capacity, the commitment of that additional capital, if substantial, would be a commitment for substantial expansion of mining activities. To the extent that any foreign loss was sustained on a per-country basis during the transition period the loss is to be subject to the general loss recapture on a per-country basis.

The Congress is also aware that a similar problem exists with respect to certain ventures begun in Puerto Rico or other possessions. Therefore, the Act applies the special transition period developed for mining ventures to existing ventures in Puerto Rico or other possessions. Thus, a taxpayer may continue to use the per-country limitation for operations in Puerto Rico for 3 additional years, and any loss sustained in those years will be subject to recapture, but on a per-country basis.

Revenue effect

It is estimated that the repeal of the per-country limitation will result in an increase in budget receipts of $51 million in fiscal year 1977, $35 million in fiscal year 1978 and $45 million in fiscal year 1981.

(2) *Foreign loss recapture*

Explanation of provisions

Repeal of the per-country limitation, as outlined above, will prevent a taxpayer who has foreign losses from reducing his U.S. tax on U.S. source income if the taxpayer also has foreign source income equal to or greater than the amount of losses. However, in a case where overall foreign losses exceed foreign income in a given year, the excess of the losses could still reduce U.S. tax on domestic source income. In this case, if the taxpayer later receives income from abroad on which he obtained a foreign tax credit, the taxpayer has received the tax benefit of having reduced his U.S. income for the loss year while not paying a U.S. tax for the later profitable year. To reduce the advantage to these taxpayers, the Congress has included a provision which requires that in cases where a loss from foreign operations reduces U.S. tax on U.S. source income, the tax benefit derived from the deduction of these losses should, in effect, be recaptured by the United States when the company subsequently derives income from abroad.

In general, the recapture is accomplished by treating a portion of foreign income which is subsequently derived as income from domestic sources. The amount of the foreign income which is to be treated as income from domestic sources in a subsequent year is limited to the lesser of the amount of the loss (to the extent that the loss has not been recaptured in prior taxable years) or 50 percent of the foreign taxable income for that year, or such larger percent as the taxpayer may choose. Thus, in any taxable year the amount subject to recapture is not to exceed 50 percent of the taxpayer's foreign income (before recharacterization) unless the taxpayer chooses to have a greater percentage of his foreign income so recharacterized. Since the amount that is recaptured represents a loss which in the previous taxable year reduced the U.S. tax on income from U.S. sources, the recaptured amount is to be treated as income from sources within the United States.

For the purposes of this recapture provision the Act defines the term "overall foreign loss" to mean the amount by which the taxpayer's (or in the case of an affiliated group filing a consolidated return, the group's) gross income from sources without the United States is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to foreign sources and a ratable part of any expenses losses or other deductions which cannot definitely be allocated to some item or class of gross income (under sec. 862(b) of the Code). If no overall foreign loss has been sustained in the case of an affiliated group of corporations filing consolidated returns, then no loss is subject to recapture even if a member of the group had a loss and the member is subsequently sold or otherwise leaves the group (e.g., a section 936 election is made with respect to the member). In computing the amount of the foreign loss, the net operating loss deduction (under sec. 172(a)) and any capital loss carryback and carryover to that year (under sec. 1212 of the Code) are not to be taken into account. In addition, foreign expropriation losses (as defined in sec. 172(k)(1) of the Code) or a loss which arises from fire, storm, shipwreck, or other casualty, or from theft (unless the loss is compensated for by insurance or otherwise) are not subject to the recapture provision. A taxpayer is to be treated as sustaining a foreign loss whether or not he claims a foreign tax credit for the year of the loss.

The Act also provides for the recapture of a loss where property which was used in a trade or business, and which was used predominantly outside of the United States, is disposed of prior to the time the loss has been recaptured under the rules discussed above. These rules are to apply regardless of whether gain would otherwise be recognized. In cases where gain would otherwise not be recognized, the taxpayer is to be treated as having received gain which is to be recognized in the year the taxpayer disposes of the property. The gain is to be the excess of the fair market value of the property disposed of over the taxpayer's adjusted basis in the property. Of course, the gain to be recognized under this provision is to be limited to the amount of the foreign losses not yet recaptured. In the case of a recapture resulting from the disposition of the property, 100 percent of the gain (to the extent of losses not previously recaptured) is recaptured. In such a case the 50-percent of gain limit is not applied, and the amount (if any) to be recaptured in future years is reduced by the full amount of the gain.

For purposes of the recapture provisions, the term "disposition" includes a sale, exchange, distribution, or gift of property whether or not gain or loss would otherwise be recognized.

If income is recognized solely because of this disposition rule, such income receives the same characterization that it would be given had the taxpayer actually sold or exchanged the property. In such cases, the Secretary of the Treasury is given the authority to prescribe appropriate regulations to provide for any necessary adjustments to the basis of the property to reflect any taxable income so recognized. However, a disposition for this purpose only includes a transfer of property which is a material factor in the realization of taxable income by the taxpayer. A disposition for this purpose does not include a transfer of property to a domestic corporation in a distribution or transfer which has carryover attributes (sec. 381(a)). Property is to be treated as a material factor in the realization of income not only if it is or was a material factor in the production of income, but also if it would be in the future.

In determining whether the predominant use of any property has been without the United States, the use of the asset during the 3 years immediately prior to the disposition (or during the entire period of use of the property, if less) is to be taken into account.

Effective date

The loss recapture provisions apply to losses sustained in taxable years beginning after December 31, 1975, with two exceptions. Since the new recapture provisions apply to all losses (oil-related and otherwise), the recapture of foreign oil-related losses is to be accomplished under the general recapture provisions of section 904. However, under the special limitation for foreign oil-related income, a separate recapture computation and reduction of the foreign tax credit limitation is made with respect to the recapture of foreign oil-related losses and other losses. Foreign oil-related losses which were subject to recapture under the provisions of section 907(f) which have not yet been recaptured are to be recaptured under the new recapture provisions.

The first exception applies to loss from a debt obligation of a foreign government. In the case of a loss from the disposition of a bond, note, or other evidence of indebtedness issued before May 14, 1976, by a foreign government or instrumentality thereof for property located in that country or stock or indebtedness of a corporation incorporated in such country, the loss recapture provision does not apply. This provision is intended to provide relief where foreign subsidiaries of domestic corporations incur losses because they were forced, under the threat of expropriation, to exchange their stock or assets for long-term debt obligations of a foreign government which yield very low interest.

The second exception applies to cases where a loss sustained in 1976 is from an investment which became substantially worthless prior to the effective date. The loss may be with respect to stock or indebtedness (including guarantees) of a corporation in which the taxpayer owned at least 10 percent of the voting stock. The termination may be by reason of sale, liquidation or abandonment of a single corporation or a group of corporations which are operated in the same line of business. To take into account more than one corporation in computing the 5-year tests, the taxpayer must terminate its operations by January 1, 1977, in all of the corporations in the group. This exception applies where a corporation has suffered an operating loss in three out of the five years preceding the year in which the loss was sustained, has sustained an overall loss for those five years, and the termination takes place before January 1, 1977.

In some cases, a corporation may want to continue an investment beyond 1976 in an attempt to try to make the investment profitable, although it may ultimately fail in that endeavor. The Act provides that if a loss would qualify for the exception to recapture but for the fact that the investment is not terminated in 1976, if the investment is terminated before January 1, 1979, there is to be no recapture of the loss to the extent there was on December 31, 1975, a deficit in earnings and profits.

Revenue effect

It is estimated that the loss recapture provisions will result in an increase in budget receipts of $2 million in fiscal year 1977, $8 million in fiscal year 1978 and $28 million in fiscal year 1981.

b. Dividends from less-developed country corporations

Prior law

Under prior law, the amount of a dividend from a less-developed country corporation included in income by the recipient domestic corporation was not increased (i.e., grossed up) by the amount of taxes which the domestic corporation receiving the dividend was deemed to have paid to the foreign government. Instead, the amount of taxes was reduced by the ratio of the foreign taxes paid by the less-developed country corporation to its pretax profits.

Reasons for change

The failure to gross-up the dividend by the amount of the foreign taxes that were deemed paid resulted, in effect, in a double allowance for foreign taxes. The problem arose from the fact that the amount paid in foreign taxes not only was allowed as a credit in computing the U.S. tax of the corporation receiving the dividend, but also was allowed as a deduction (since the dividends could only be paid out of income remaining after payment of the foreign tax). The result was that the combined foreign and U.S. tax paid by the domestic corporation was less than 48 percent of the taxpayer's income in cases where the foreign tax rate of the less-developed country corporation was lower than the 48 percent U.S. corporate tax rate (but above zero).[6] In

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[6] For example, assume that a foreign country imposes a 30-percent tax on $1,000 of income. If the foreign corporation earns $1,000 as a less-developed country corporation in that country, a distribution by that corporation of the remaining $700 to its U.S. parent corporation would result in $700 income to the U.S. parent. The parent's U.S. tax would be $336 before allowance of a foreign tax credit. In calculating the foreign tax credit, the $300 amount of foreign taxes paid would be reduced by 300/1000 to $210. The $210 could then be credited against U.S. tax liability of $336, leaving a net liability of $126. Thus, the combined U.S. tax and foreign tax liability on the original $1,000 of income would be $426 ($300 foreign taxes plus $126 U.S. tax), not the $480 which should be paid at a 48 percent rate.

If that same foreign corporation earning $1,000 were not a less-developed country corporation, the entire 1,000 would be included in the parent corporation's income if it received a dividend of $700 which would carry with it foreign taxes of $300. In this case, the U.S. tax before credit would be $480. The entire $300 of foreign taxes would be credited, leaving a U.S. tax liability of $180. The combined U.S. tax and foreign tax liabilities would be $480.

cases where the foreign tax rate exceeded 48 percent, the dividend did not bring with it all the foreign taxes that were paid and thus the size of foreign tax credit carryover was reduced.

The size of the tax differential which existed in the case of dividends from less-developed country corporations varied with the foreign tax rate, as can be seen by the table below:

TABLE 1.—RATE DIFFERENTIAL ENJOYED WITH RESPECT TO DIVIDENDS FROM LESS-DEVELOPED COUNTRY CORPORATIONS WITH VARIOUS SELECTED FOREIGN INCOME TAX RATES AND PRESENT 48 PERCENT U.S. RATE

Income before tax	Foreign tax	Income available for dividend	U.S. tax before credit	Credit against U.S. tax	U.S. tax	Total tax	Rate differential enjoyed by foreign subsidiary (percent)
$100	0	$100	$48.00	0	$48.00	$48.00	0
$100	$10	90	43.10	$9.00	34.20	44.20	3.90
$100	20	80	38.40	16.00	22.40	42.40	5.60
$100	24	76	36.48	18.24	18.24	42.24	5.76
$100	30	70	33.60	21.00	12.60	42 60	5.40
$100	40	60	28.80	24.00	4.80	44.80	3.20
$100	48	52	24.96	24.96	0	48.00	0
$100	55	45	21.50	24.75	*0	55.00	0

* Excess credits of 3.25 are generated.

Further, the tax differential disappeared either when the foreign tax rate equaled or exceeded the U.S. tax or when there was no foreign tax imposed at all. The maximum tax differential, given a 48-percent U.S. tax rate, occurred when the foreign tax was half that, or 24 percent. The differential at this point was 5.76 percentage points.

The Congress believes that in the interest of uniform tax treatment between developed and less-developed country corporations and among all less-developed country corporations, this double allowance should be removed. Further, providing for identical treatment between all foreign corporations simplifies the foreign tax credit computation.

Explanation of provision

Under the Act, dividends from less-developed country corporations are treated the same as dividends from other foreign corporations. Thus, the amount of the dividends is increased by the amount of taxes deemed paid with respect to that dividend.

Effective date

For distributions out of current income, the provision is effective for taxable years beginning after December 31, 1975. However, the Act provides that for distributions made by less developed country corporations in taxable years beginning after December 31, 1975, and received by domestic corporations before January 1, 1978, this provision applies only to the extent that the distributions are made out of profits of the foreign corporation accumulated in taxable years (of such foreign corporation) beginning after December 31, 1975. Thus, during that period, distributions of a less-developed country corporation out of profits accumulated in taxable years beginning before January 1, 1976, are taxed as under prior law. After January 1, 1978, however, the provisions of this Act apply to all distributions regardless of the year in which the profits are accumulated.

Revenue effect

It is estimated that this provision will increase budget receipts by $80 million in fiscal year 1977 and by $55 million thereafter.

c. Treatment of capital gains

Reasons for change

The prior foreign tax credit limitation created a number of problems in the treatment of capital gains stemming from the fact that capital gains are taxed differently than ordinary income. In many cases the source of income derived from the sale or exchange of an asset is determined by the location of the asset, or, if the asset is personal property, by the place of sale (i.e., the place where title to the property passes). In the latter case, taxpayers could often exercise a choice of the country from which the income from the sale of personal property is to be derived. It has thus been possible, in some cases, for a taxpayer to plan sales of personal property (including stocks or securities) in such a way as to maximize use of foreign tax credits by arranging that the sale of that property take place in a certain country.

Since most countries (including the United States) impose little, if any, tax on sales of personal property by foreigners if the sales are not connected with a trade or business in that country, the prior system permitted taxpayers to plan sales of their assets in such a way that the income from the sale resulted in little or no additional foreign taxes and yet the amount of foreign taxes they could use as a credit against their U.S. tax liability was increased.

Further problems in the treatment of income from the sale or exchange of assets for purposes of the foreign tax credit limitation were presented because prior law included no explicit rules for netting long-term and short-term gains and losses in cases where some gains or losses are U.S. source income while other gains or losses are foreign source income. The Internal Revenue Service has held that if a taxpayer (in certain circumstances) had losses from sources within the United States and had gains from sources outside the United States, the domestic losses did not offset the foreign gains for purposes of determining taxable income from sources without the United States in the limiting fraction of the per-country or overall limitation on foreign tax credits. For example, if a taxpayer had long-term gain from sources outside the United States, that gain would increase income from sources without the United States and thus would increase the amount of foreign tax credits allowed to reduce U.S. tax liability, even though that gain had no effect on the taxpayer's pre-credit U.S. tax liability because it was offset by U.S. source capital losses. The result is that in a case of foreign gains and domestic losses the amount of foreign tax credits which could be used was increased without a commensurate increase in U.S. tax liability; U.S. tax on U.S. income was reduced. Where foreign losses reduced U.S. gains, the amount of the allowable credit was improperly reduced.

A problem with the treatment of capital gains under the foreign tax credit system was also presented by the fact that the credit limitations were not adjusted to reflect the lower tax rate on capital gains income received by corporations.[7] Under prior law, corporations hav-

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[7] A similar problem exists to a much lesser extent for capital gains income of individuals under the alternative tax (secs. 1201 (b) and (c)). However, since only a limited amount of income is eligible for this treatment it was felt unnecessary to deal with this problem.

ing a net long-term capital gain in most instances pay only a 30-percent rate of tax on the gain. But for purposes of determining foreign source and worldwide income in the limiting fraction of the foreign tax credit limitation, income from long-term capital gain was treated the same as ordinary income (i.e., as if it were subject to a 48-percent rate of tax).[8] Similarly, a corporation which had capital gain income from U.S. sources and had foreign source income that was not capital gain did not receive a full credit for the amount of U.S. tax attributable to foreign source income.[9]

Finally, in computing the foreign tax credit limitation, the numerator of the limiting fraction was reduced by the amount of the net capital losses from sources without the United States which were taken into account in computing the taxpayer's entire taxable income for the year (i.e., to the extent that they were deductible as offsets against capital gain net income from sources within the United States). However, no adjustment was made under prior law to account for the lower rate where the net capital loss from sources without the United States offset long-term capital gains from sources within the United States, even though the gains would have only been subject to tax at a 30-percent rate if the foreign loss had not been sustained. Thus, while the foreign source capital losses reduced long-term capital gains for purposes of computing taxable income, the impact on the computation of the foreign tax credit limitation was for the foreign source capital losses to reduce foreign source ordinary income. Consequently, the loss reduced the taxpayer's foreign tax credit limitation by an amount greater than the tax which would have been imposed on the U.S. source gain in the absence of the loss, and the taxpayer's net U.S. tax after the foreign tax credit was higher than it would have been had it not sustained the loss.

The Congress believes that adjustments should be made to the foreign tax credit limitation to take into account the fact that capital gains are taxed differently from ordinary income.

Explanation of provisions

The Act includes three provisions altering the treatment of income from the sale of capital assets for purposes of computing the limitation on the foreign tax credit. The Act establishes specific rules for determining the extent to which income or loss from the sale or exchange of capital assets from sources outside the United States is to be included in the limiting fraction in calculating the foreign tax credit limitation.

The amount of capital gain included in foreign source income is referred to as "foreign source capital gain net income", defined as the lower of capital gain net income from sources without the United States or capital gain net income. (Capital gain net income is the ex-

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[8] For example, if a corporation had worldwide income of $20 million, $10 million of which was ordinary income from sources within the United States and $10 million of which was income from the sale of a capital asset from sources without the United States, that corporation was allowed a foreign tax credit equal to one-half (10/20) of its U.S. tax liability, even though only $3 million of the $7.8 million in U.S. tax liability was attributable to foreign source income. Prior law thus favored the taxpayer with foreign source capital gain since its U.S. tax on foreign income of $10 million was not treated as being $3.0 million but as $3.9 million.

[9] For example, if such a taxpayer had $10 million of U.S. source capital gain and $10 million of foreign ordinary income, the foreign tax credit limitation would limit the credit to $3.9 million even though it would be liable for $4.8 million of U.S. tax on its foreign source income.

cess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.) Thus, under this provision, foreign source capital gain can be used to increase the amount of tax credits available to offset U.S. tax liability only to the extent the foreign source capital gain results in a foreign source capital gain net income. In cases where foreign and net U.S. losses equal or exceed foreign gains, the foreign gains will not be taken into account for purposes of determining the limitation.

The second adjustment for capital gains income of corporations under the foreign tax credit limitation provides that the foreign source capital gain net income taken into account is to be reduced by three-eighths of foreign source net capital gain. Foreign source net capital gain is defined as the lower of the net capital gain from sources without the United States or net capital gain. (Net capital gain is the excess of net long-term capital gain over net short-term capital loss.) In effect a maximum of 30/48ths of the net long-term capital gain from sources without the United States is taken into account.[10] This reduction of income is made to prevent distortion in the amount of foreign tax credits allowable to foreign income which would result because capital gains for corporations is taxed at a 30-percent rate rather than a 48-percent rate.[11]

Further to the extent that a net capital loss from sources without the United States is taken into account in determining capital gain net income for the taxable year (i.e., to the extent that a net capital loss from sources without the United States is allowed as a deduction in computing taxable income for the taxable year because it offsets capital gain net income from sources within the United States) and thus reduces the numerator, the loss is reduced (and thus the numerator is increased) by three-eighths of the excess of net capital gain from sources within the United States over net capital gain. Since the amount of the deductible net capital loss from sources without the United States is not as such taken into account as a separate element in computing the denominator of the foreign tax credit limitation, no adjustment is made to the denominator of the fraction in this situation.[12]

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[10] If a corporation has, for example, $100 of net long-term capital gain from sources without the United States, all of which is foreign source capital gain net income, that corporation includes as foreign source income only a maximum of 30/48ths (or ⅝ths) thereof. Assuming that all of the corporation's foreign source capital gain net income qualifies as foreign source net capital gain, the corporation is permitted only $30 in tax credits attributable to the $100 of foreign source income, rather than the $48 in foreign tax credits which would be permitted without the reduction in capital gain income. Similarly, a company which has $100 in domestic capital gain income and $100 in foreign source ordinary income includes as U.S.-source income 30/48ths of its U.S. source net capital gain. Such a corporation has a $48 limitation on foreign tax redits attributable to the $100 of foreign income rather than $39 as would be permitted without the reduction in capital gains income.

[11] A similar adjustment is not needed in the case of taxpayers other than corporations (even though the alternative tax might be used) since in computing taxable income for purposes of the foreign tax credit limitation a deduction is taken for long-term capital gains (sec. 1202).

[12] This provision may be illustrated by the following example. Assume a corporation has a U.S. source long-term capital gain of $50, a U.S. short-term capital gain of $25, a foreign source long-term capital gain of $100, and a foreign source long-term capital loss of $200. The taxpayer also had U.S. source ordinary income of $1,000 and foreign source ordinary income of $100. Only $75 of the corporation's net foreign source capital loss is taken into account in computing its capital gain net inome of zero for the taxable year, and its net capital gain from U.S. sources of $50 exceeds its worldwide net capital gain of zero by $50. Thus, the numerator of the foreign tax credit limitation is reduced by $56.25 ($75 less than three-eighths of $50). Therefore, the numerator is $43.75 ($100 less $56.25), and the denominator is $1,100. On the basis of a tentative U.S. tax of $528, the foreign tax credit limitation is $21, and the U.S. tax after the credit is $507, the same amount of tax the corporation would be liable for if its foreign source income, gains and losses were disregarded.

The Act also provides a special rule which applies to personal property sold outside of the United States by a corporation or by an individual (if sold or exchanged outside of the country of the individual's residence). In these cases, no income is included for purposes of calculating the numerator of the foreign tax credit limitation from such sales or exchanges if the country in which such property is sold does not impose an income, war profits, or excess profits tax at a rate at least equal to 10 percent of the gain from the sale or exchange as computed under U.S. tax rules. This is accomplished by treating the foreign source capital gain as U.S. source income. The purpose of this rule is to prevent taxpayers from selling their assets abroad primarily to utilize any excess foreign tax credits which they may have available from other activities. It was concluded that if the foreign government significantly taxes a sale, that sale probably did not take place in that country purely for tax purposes. The Congress concluded that a tax of 10 percent of the gain was substantial for these purposes.

The rules treating foreign source capital gain as U.S. source income do not apply in three situations, even though no foreign tax is paid on the gain. These cases involve situations where the sale is not made in a country purely for tax purposes and, thus, an exception to the general rule should be made. The three cases are: first, in the case of a sale by an individual, if the property is sold or exchanged within the individual's country of residence; second, in the case of a sale by a corporation of stock in a second corporation, if the stock is sold in a country in which the second corporation derived more than 50 percent of its gross income for the 3-year period ending with the close of the second corporation's taxable year immediately preceding the year during which the sale took place; and third, in the case of a sale by a corporation or an individual of personal property (other than stock in a corporation), if the property is sold in a country in which such property was used in a trade or business of the taxpayer or in which the taxpayer derived more than 50 percent of its gross income for the 3-year period ending with the close of its taxable year immediately preceding the year during which the sale took place.

The changes in capital gains income generally are to apply both to capital assets and to business assets if such assets are treated as capital assets under the applicable Code provision. The new rules for capital gains are to be applied before application of the rules dealing with the recapture of foreign losses.

Effective dates

These provisions are to take effect with respect to gains and losses recognized in taxable years beginning after December 31, 1975, except that the rule which treats certain foreign source gain as U.S. source gain only applies to sales or exchanges made after November 12, 1975.

Revenue effect

It is estimated that the capital gain provisions will result in an increase in budget receipts of $14 million in fiscal year 1977 and $10 million thereafter.

d. Foreign oil and gas extraction income

(1) Limitation on oil and gas extraction income

Reasons for change

Under prior law, the amount of foreign taxes paid with respect to foreign oil and gas extraction income which under U.S. law were creditable taxes with respect to foreign oil and gas extraction income was limited to 50 percent of that income on an overall basis for taxable years ending after 1976. For purposes of this limitation "foreign oil and gas extraction income" is the income derived by the taxpayer from extraction (by the taxpayer or any other person) of minerals from oil and gas wells. Income from extraction includes the purchase and sale of crude oil by the taxpayer in cases where the taxpayer is not performing the extraction operations. Also it includes cases where the taxpayer is performing extraction services within the country for the government of that country (whether or not the taxpayer may purchase the oil from that government). Any extraction tax allowed could only be used to offset U.S. tax on oil-related income in that year. No carryback or carryforward on any excess tax was permitted.

Explanation of provision

Under the Act, the limitation on foreign taxes on foreign oil and gas extraction income allowable as a foreign tax credit is reduced for taxable years ending after 1976 to 48 percent of the foreign oil and gas extraction income computed on an overall basis. The 48-percent figure is the sum of the normal tax rate and the surtax rate for the taxable year in which the credit is claimed. Thus, if either of these two rates should be increased or decreased, the 48-percent limitation would also be changed. Further, a definition of foreign oil and gas extraction taxes is provided in order to make clear that the term includes creditable taxes paid to a foreign country where there is no taxable income in that country under U.S. tax accounting rules. The term "foreign oil and gas extraction taxes" is defined to mean any income, war profits, and excess profits tax paid or accrued (or deemed to have been paid under sec. 902 or 960) with respect to foreign oil and gas extraction income. This determination of foreign oil and gas extraction income is to be made without regard to whether there was, under U.S. accounting rules, a loss described in section 907(c)(4) from oil or gas extraction operations in the taxing country. The determination also includes any tax on foreign oil and gas extraction operations which would be taken into account as a tax in computing the foreign tax credit under section 901 if section 907 of the Code did not so limit the allowability of that tax as a credit.

The Act provides carryback and carryover rules for excess foreign oil and gas extraction taxes. Under the Act, foreign oil and gas extraction taxes paid in taxable years ending after the date of enactment which exceed the percentage limitation for the year can be carried back 2 years to taxable years ending after December 31, 1974, and can be carried forward for 5 years in a manner similar to the regular foreign tax credit rules. The amount of the tax which is entitled to this new carryback or carryforward treatment may not exceed 2 percent of the foreign oil and gas extraction income for the year. Thus, amounts in excess of 50 percent of the foreign oil and gas extraction income for the year are not allowed as a creditable tax in the current or carryover year. For purposes of determining the amount of taxes which may be carried to a taxable year ending in 1975, 1976, or 1977, the Act provides a transition rule which permits a carryover of excess credits in addition to the 2 percent allowed under the general new carryover rule.

Special rules are provided which are designed to prevent the carryover of credits disallowed under section 907 for extraction taxes paid or accrued in a year (the "unused credit year") to any year in which the credits could not be used because they would exceed either the section 907 limitation for that year or the section 904 limitation on oil-related taxes for that year. Under the special rules, the amount of extraction taxes which can be carried to a year under section 907 cannot exceed the lesser of two limits. The first limit prevents the carryover of taxes to a year if they would exceed the section 907 limitation for the year. The limit is the amount by which the section 907 limitation for the year to which the taxes are to be carried exceeds (i) the sum of the extraction taxes actually paid in that year plus (ii) the amount of extraction taxes carried to that year from years prior to the unused credit year. The second limit prevents the carryover of taxes which would exceed the section 904 limitation on foreign oil-related income for the year to which the taxes are carried. The limit is the amount by which the section 904 limitation exceeds the sum of (i) the amount of foreign oil-related taxes paid or accrued (or deemed paid under sec. 902 or 960) during the year, (ii) the amount of foreign oil-related taxes carried to that year under section 904(c) from years preceding the unused credit year, and (iii) amount of oil extraction taxes carried to that year under section 907 from years preceding the unused credit year.

Where a taxpayer's extraction taxes exceed the section 907 limitation for a year and its oil-related taxes exceed the section 904 limitation for the year, the carryover under section 907 is to be made before the carryover under section 904(c). In determining the amount of oil-related taxes which can be carried to a year from the unused credit year under section 904(c), an overlap of carryovers to that year is prevented by treating the extraction taxes carried to that year from the unused credit year as actually having been paid during that year (thereby reducing the amount which could be carried to that year under sec. 904(c) by the amount of extraction taxes carried to that year under sec. 907).

Effective dates

The reduction in the percentage limitation of the foreign tax credit for foreign oil and gas extraction taxes applies to taxable years ending after December 31, 1976. The new carryover provisions are to apply to taxes paid or accrued during taxable years ending after the date of enactment of the Act.

Revenue effect

It is estimated that the provisions dealing with limitation and carryover of foreign oil and gas extraction taxes will result in an increase in budget receipts of $23 million in fiscal year 1977, and $50 million thereafter.

(2) *Foreign oil-related income earned by individuals*

Reasons for change

As indicated above, the foreign tax credit that can be claimed for foreign oil and gas extraction income is limited by a percentage of that income, and the amount of U.S. taxes that can be offset by these taxes in any year is subject to a separate overall limitation based on foreign oil-related income.

Foreign oil-related income includes (in addition to extraction income) income from processing, transportation, and distribution activities. These items are not included in foreign oil and gas extraction income. Under prior law, individuals and corporations were subject to the same percentage limitation. However, it is believed that individuals seldom have foreign oil-related income which is not also included in foreign oil and gas extraction income. In addition, limiting the amount of creditable taxes to the corporate rate is unfair or unduly generous in the case of certain individuals. For example, if an individual has a high effective rate of tax (in excess of the corporate rate), his disallowed foreign tax credit will cause him to pay U.S. tax on his foreign extraction income, while a corporation would owe no U.S. tax.

Explanation of provision

The Act limits the allowable foreign tax credit on foreign oil and gas extraction income to an amount equal to the average U.S. effective rate of tax on that income. Thus, in any case there will be sufficient tax credits to offset the U.S. tax on the foreign oil and gas extraction income but no excess credits to offset U.S. tax on other foreign source income. The Act achieves this result by limiting the taxpayer to a separate overall foreign tax credit limitation for foreign oil and gas extraction income.

Effective date

This provision is effective for taxable years ending after December 31, 1974.

Revenue effect

It is estimated that this provision will decrease revenues by less than $5 million on an annual basis.

(3) *Production-sharing contracts*

Reasons for change

A problem concerning the allowance of a foreign tax credit for payments to a foreign government in connection with mineral extraction arose in the case of production-sharing contracts. These arrangements between the foreign government and oil companies which are becoming increasingly popular involve government ownership of all oil and gas reserves. Under these arrangements, the oil company operates as a contractor furnishing services and know-how. All management and control of production is retained by a government-owned entity which has the exclusive right to explore and develop the government's mineral property. All tangible property is owned by the government-owned entity. Ordinarily, the contractor is compensated for its costs in the form of a share (not to exceed a given percentage each year) of the production from a contract area. The remainder of the production is divided between the contractor and the government-owned entity according to negotiated percentages. (Any unrecovered costs are recovered in subsequent years.) The law of the foreign country generally provides that the government-owned oil company is to pay to the government each year a portion of its production share. This payment is said to constitute (among other things) the payment of the contractor's tax liability on its behalf so that the contractor does not directly pay any income taxes under the country's general corporation tax.

The Internal Revenue Service issued Revenue Ruling 76–215, 1976 I.R.B. No. 25, holding that the contractor under a production-sharing contract in Indonesia is not entitled to a foreign tax credit for payments made by the government-owned company to the foreign government. The grounds for this holding were, in part, that since the foreign government already owns all of the oil and gas, there is no payment to the government by the contractor. Furthermore, even if a payment by, or on behalf of, the contractor could be identified, the IRS views such a payment as in the nature of a royalty, rather than a tax.

In 1969, the Internal Revenue Service issued Revenue Ruling 69–388, 1969–2 C.B. 154, which held that certain payments made pursuant to a contract to explore for, develop, and produce oil in Indonesia are creditable. The contracts to which that Ruling applied were not production-sharing contracts but the Ruling was apparently relied on by oil companies entering into production-sharing contracts. In view of the fact that the scope of the prior Ruling was not clear, the Internal Revenue Service exercised its discretion to apply Revenue Ruling 76–215 only prospectively to claims for credits for taxes paid in taxable years beginning after June 30, 1976.

While the Congress takes no position on the correctness of the IRS ruling, the Congress feels that oil companies operating under existing production-sharing contracts should have a reasonable time to renegotiate their contracts with the foreign government. Thus, assuming the ruling is sustained, if challenged, generally the companies should continue to be allowed the foreign tax credit for another year. In the meantime, however, the oil companies should not be allowed to generate excess foreign tax credits under the contracts that can be used to offset tax on other income.

Explanation of provision

The Act allows a limited foreign tax credit for a limited period in the case of certain production-sharing contracts to which Revenue Ruling 76–215 applies. Under this provision, amounts which are designated by a foreign government under certain production-sharing contracts as income taxes are treated as creditable income, war profits, and excess profits taxes even though the amounts would not otherwise be treated as creditable taxes. Moreover, the provision only applies to taxes not creditable by reason of that ruling. Thus, to the extent that payments are treated as taxes, this provision does not apply to those payments.

However, the total amount treated as creditable taxes under this provision is not to exceed the lesser of two amounts. The first amount is the total foreign oil and gas extraction income with respect to production-sharing contracts covered under the rule multiplied by the U.S. corporate tax rate (presently 48 percent) less the otherwise allowable (if any) foreign tax credits attributable to income from those contracts. The second amount is the total foreign oil and gas extraction income multiplied by the U.S. corporate tax rate (generally 48 percent) less the total amount of the otherwise allowable foreign tax credits (if any) attributable to the total foreign oil and gas extraction income.

The production-sharing contracts covered by this provision are those contracts for which the IRS has published a ruling disallowing foreign tax credits for taxes paid in taxable years beginning on or after June 30, 1976, but has not disallowed claims for tax credits for taxable years beginning before that date.

Thus, for example, assume that the taxpayer for 1977 derives a total of $100 of foreign oil and gas extraction income; that $10 of that amount is derived from production-sharing contracts to which this provision applies; that the taxpayer pays a total of $45 in foreign taxes on the foreign extraction income (not including any amounts claimed as taxes under production-sharing contracts to which this provision applies); and that $6 of tax credit was disallowed on the income from the production-sharing contracts. Under these facts, the taxpayer is allowed a foreign tax credit for amounts under the production-sharing contract equal to $3, the lesser of (48 percent of $10) or ((48 percent of $100) minus $45).

The special rule applies only with respect to production-sharing contracts for which the Internal Revenue Service will disallow claims for a foreign tax credit for taxes paid in taxable years beginning on or after June 30, 1976, but will not disallow claims for taxes paid for taxable years beginning on or after June 30, 1976.

Effective date

The special rule for production-sharing contracts is to apply for taxable years beginning on or after June 30, 1976. This provision will apply only to production-sharing contracts entered into before April 8, 1976, and will apply only with respect to taxable years ending before January 1, 1978.

Revenue effect

It is estimated that this provision will decrease budget receipts by $23 million in fiscal year 1977 and $27 million in fiscal year 1978.

e. Third-tier foreign tax credit under subpart F

Prior law

Under existing law, when amounts which are foreign base company income are included in the income of a domestic corporation under subpart F with respect to the undistributed earnings of a controlled foreign corporation, a proportionate part of the foreign taxes paid by the foreign corporation are deemed paid by the domestic corporation, and a foreign tax credit is available to the domestic corporation with respect to those taxes. These rules are substantially parallel to the foreign tax credit rules on actual distributions. However, this deemed paid credit was available under prior law for subpart F income only if the controlled foreign corporation was a first-tier foreign corporation (which must be at least 10 percent owned by a domestic corporation) or a second-tier foreign corporation (which must be at least 50 percent owned by a first-tier foreign corporation).

Reasons for change

The rules with respect to second- and third-tier corporations were inconsistent with the foreign tax credit rules applicable with respect to dividends actually distributed. Actual dividends carry with them a proportionate part of the foreign taxes paid by third-tier foreign corporations, as well as first- and second-tier foreign corporations. Moreover, in order to qualify as a second-tier corporation with respect to dividends actually distributed, only 10 percent of the stock need be held by a first-tier foreign corporation.

The Congress believes that the foreign tax credit rules with respect to amounts included in income under subpart F should be consistent with the rules applicable to dividends actually distributed. Taxpayers tend to structure their business operations in accordance with the rules applicable with respect to actual distributions. The rules of subpart F were overly harsh when they denied a foreign tax credit to a taxpayer who would have been entitled to a credit had there been an actual distribution.

When subpart F was added in 1962, the rules for computing the deemed-paid foreign tax credit with respect to dividends were applicable only with respect to foreign taxes paid by a first-tier foreign subsidiary (defined as being at least 10 percent owned by a domestic corporation) or a second-tier foreign subsidiary (defined as being at least 50 percent owned by a first-tier foreign corporation). The foreign tax credit rules under subpart F were made applicable under the same circumstances as actual dividends. In 1971, the deemed-paid foreign tax credit with respect to dividends actually distributed was expanded to apply to foreign taxes paid by a larger class of second-tier corporations and by third-tier foreign corporations. The Act conforms the subpart F foreign tax credit rules to the 1971 change in the deemed-paid foreign tax credit rules for actual dividend distributions.

Explanation of provision

The Act makes two changes to the rules for computing a foreign tax credit with respect to amounts included in income under subpart F. First, the Act provides that the foreign tax credit is applicable with respect to foreign taxes paid by a third-tier foreign corporation whose undistributed income is taxed to the shareholder. Second, the Act liberalizes the stock ownership test applicable to second-tier foreign corporations.

Under the Act, a foreign corporation qualifies as a second-tier foreign corporation if at least 10 percent of its voting stock is owned by a first-tier foreign corporation, at least 10 percent of the voting stock of which must be owned by a domestic corporation. A foreign corporation qualifies as a third-tier foreign corporation if at least 10 percent of its voting stock is owned by a second-tier foreign corporation.

However, with respect to a second-tier foreign corporation, the foreign tax credit is not available unless the percentage of voting stock owned by the domestic corporation in the first-tier foreign corporation and the percentage of voting stock owned by the first-tier foreign corporation in the second-tier foreign corporation when multiplied together equal at least 5 percent. With respect to a third-tier foreign corporation, the foreign tax credit is not available unless the percentage of voting stock in the first-tier foreign corporation owned by the domestic corporation and the percentage of voting stock in the second-tier foreign corporation owned by the first-tier foreign corporation and the percentage of voting stock in the third-tier foreign corporation owned by the second-tier foreign corporation when multiplied together equal at least 5 percent.

Effective date

The Act applies with respect to earnings and profits of a foreign corporation included in gross income after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $4 million in fiscal year 1977, $10 million in fiscal year 1978, and $10 million in fiscal year 1981.

f. Source of underwriting income

Prior law

Under prior law, the source of insurance underwriting income was unclear. Neither the Internal Revenue Code nor the Income Tax Regulations set forth a specific rule for determining the source of insurance underwriting income. It was apparently the position of the Internal Revenue Service, however, that the source of such income was to be determined on the basis of where the incidents of the transaction which produced the income occurred. Under this rule, income produced from insurance underwriting contracts negotiated and executed in the United States, regardless of the location of the insured risks, was generally deemed to be from sources within the United States. This rule apparently applied even though the insurance contract was actually written by a foreign company.

Reasons for change

The prior source rule applicable to insurance underwriting income was vulnerable to artificial manipulation by taxpayers. By simply changing the place where a contract was negotiated and executed, a taxpayer could change the source of the underwriting income produced by the contract. The prior source rule in some situations also could result in double taxation. It is not uncommon for United States corporations doing business abroad through foreign subsidiaries to negotiate and execute insurance contracts in the United States which cover its overseas operations. The insurance policies, however, frequently must be issued in the foreign jurisdiction in which the insured's risk is located in order to comply with local insurance laws or for other business reasons. Although the underwriting income in these circumstances generally would be subject to foreign taxation, the income would be deemed United States source income, which in turn would reduce the amount of the foreign tax credit available to the taxpayer.

Explanation of provision

The Act clearly establishes a source rule applicable to insurance underwriting income under which underwriting income derived from the insurance of U.S. risks will be income from sources within the United States. All other underwriting income will be considered income from sources without the United States. The source rule is not intended to change the law with respect to the determination of whether foreign source income is effectively connected with the conduct of a trade or business within the United States.

Effective date

The provision applies to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will decrease receipts by less than $5 million annually.

6. Exclusion From Gross Income and From Gross Estate of Portfolio Investments in the United States of Nonresident Aliens and Foreign Corporations (sec. 1041 of the Act and sec. 861 of the Code)

Prior law

Interest, dividends and other similar types of income of a nonresident alien or a foreign corporation are generally subject to a 30-percent tax on the gross amount paid [1] if the income or gain is not effectively connected with the conduct of a trade or business within the United States (secs. 871(a) and 881).[2] Prior law provided a temporary exemption from the tax for interest earned on deposits with banks, savings and loan institutions, and insurance companies (secs. 861(a)(1)(A) and 861(c)). Under prior law that temporary exemption would have expired for interest paid or credited after December 31, 1976.

Bank deposits owned by nonresident aliens are exempt from Federal estate tax if interest on the deposits, were it received by the decedent at the time of his death (secs. 2104 and 2105), would be exempt under the Code from the 30-percent withholding tax.

In addition to the exemption from the 30-percent withholding tax provided in the Internal Revenue Code for interest on bank deposits, various income tax treaties of the United States provide for either an exemption or a reduced rate of tax for interest paid to foreign persons if the income is not effectively connected with the conduct of a trade or business within the United States.

Reasons for change

Interest on bank deposits paid to nonresident aliens and foreign corporations has been exempt from U.S. tax continuously since 1921. The exemption was permanent prior to 1966. In the Foreign Investors Tax Act of 1966, the exemption was put on a temporary basis because Congress felt there was some question whether it was appropriate that foreign investors should receive more favorable treatment with respect to bank account interest than citizens and residents of the United States, but it wished to retain the exemption temporarily so

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[1] This tax is generally collected by means of a withholding by the person making the payment to the foreign recipient of the income (secs. 1441 and 1442).

[2] If the interest, dividend or other similar income is effectively connected with a U.S. trade or business, that income is included in the normal income tax return which must be filed for the business.

that it could determine whether the elimination of exemption would have a substantial adverse balance of payments effect.

Congress has concluded that the elimination of the exemption would result in a significant decline in the substantial deposits by nonresident aliens and foreign corporations in banks in the United States. Since a possible shortage of investment capital presently exists in the United States, Congress concluded further that it would not be advisable at this time to permit the exemption to expire at the end of 1976 with the resultant outflow of investment capital.

Moreover, it was decided to retain the exemption on a permanent basis. It is believed that the temporary nature of the exemption in recent years may have discouraged foreign investors from investing in fixed term bank deposits such as certificates of deposit where those obligations were due to mature after the dates the exemption was due to expire. Although the exemption had in the past been extended each time it was due to expire, some foreign investors (as the expiration came near) who desired to invest in fixed-term obligations because they tend to bear a relatively high interest rate apparently felt that they could not take the risk that the exemption would not be extended, and thus they invested their funds elsewhere.

Explanation of provision

The Act continues without any termination date the exemption in prior law for interest earned by nonresident aliens and foreign corporations on deposits with banks, savings and loan institutions, and insurance companies where the interest is not effectively connected with the conduct of a trade or business within the United States. The Act makes the exemption for interest on deposits permanent by eliminating the language of prior law which would have terminated the provision for interest paid or credited after December 31, 1976.

Effective date

The provision is effective upon enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by $55 million in fiscal year 1977, $115 million in fiscal year 1978, and $145 million in fiscal year 1981.

7. Changes in Ruling Requirements Under Section 367 and Changes in Amounts Treated as Dividends (sec. 1042 of the Act and secs. 367, 1248, and 7477 of the Code)

Prior law

Certain types of exchanges relating to the organization, reorganization, and liquidation of a corporation can be made without recognition of gain to the corporation involved or to its shareholders. Under prior law, however, when a foreign corporation was involved in certain of these types of exchanges, tax-free treatment was not available unless prior to the transaction the Internal Revenue Service had made a determination that the exchange did not have as one of its principal purposes the avoidance of federal income taxes. Under prior practice this determination was made by issuing a separate ruling for each transaction. The required determination had to be obtained before the transaction began in all cases unless the transaction involved only a change in the form of organization of a second (or lower) tier foreign subsidiary with no change in ownership.

The advance ruling requirement of section 367 applied to exchanges involving contributions of property to controlled corporations (sec. 351), all tax-free corporate reorganizations (secs. 354, 355, 356 and 361), and liquidations of subsidiary corporations (sec. 332). In determining the extent to which gain (but not loss) was recognized in these exchanges, a foreign corporation was not considered a corporation unless it was established to the satisfaction of the Internal Revenue Service that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Since corporate status is essential to qualify for the tax-free organization, reorganization and liquidation provisions, failure to satisfy the Commissioner under section 367 could result in the recognition of gain to the participant corporations and shareholders. Furthermore, there was no effective way a taxpayer could appeal an adverse decision by the Commissioner to the courts because the statute required the Commissioner's, not the court's, satisfaction.

In 1968, the Internal Revenue Service issued guidelines (Rev. Proc. 68–23, 1968–1 Cum. Bull. 821) as to when favorable rulings "ordinarily" would be issued. As a condition of obtaining a favorable ruling with respect to certain transactions, the section 367 guidelines required the taxpayer to agree to include certain items in income (the amount to be included was called the section 367 toll charge). For example, if a domestic corporation transferred property to a foreign subsidiary (a transaction otherwise accorded tax-free treatment under section 351), the transaction was given a favorable ruling only if the domestic corporation agreed to include in its gross income for its taxable year in which the transfer occurred an appropriate amount to reflect realization of income or gain with respect to certain types of assets (*e.g.*, inventory, accounts receivable, and certain stock or securities) transferred to the foreign corporation as part of the transfer. If the transaction involved the liquidation of a foreign corporation into a domestic parent, a favorable ruling was issued if the domestic parent agreed to include in its income as a dividend for the taxable year in which the liquidation occurred the portion of the accumulated earnings and profits of the foreign corporation which were properly attributable to the domestic corporation's stock interest in the foreign corporation. These two cases illustrate that the statutory standard for determining that a transaction did not have as one of its principal purposes tax avoidance had evolved through administrative interpretation into a requirement generally that tax-free treatment would be permitted only if the U.S. tax on accumulated earnings and profits (in the case of transfers into the United States by a foreign corporation) or the U.S. tax on the potential earnings from liquid or passive investment assets (in the case of transfers of property outside the United States) was paid or was preserved for future payment.

In addition to section 367, section 1248 provided for the imposition of a full U.S. tax on accumulated profits earned abroad when they were repatriated to the United States in cases where gain was recognized on the sale or exchange (or liquidation) of stock of a controlled foreign corporation held by a U.S. person owning 10 percent or more of the voting stock. In these cases, the gain was included in the gross income of the U.S. person as a dividend to the extent of the earnings and profits of the foreign corporation attributable to the period the stock was held by the U.S. person while the foreign corporation was a controlled foreign corporation. This provision applied to post-1962 accumulated earnings.

Reasons for change

Several problems developed insofar as section 367 and the related provisions of section 1248 were concerned. First, the advance ruling requirement often resulted in an undue delay for taxpayers attempting to consummate perfectly proper business transactions. Second, a number of cases had arisen where a foreign corporation was involved in an exchange within the scope of the section 367 guidelines without the knowledge of its U.S. shareholders, and thus no request for prior approval had been made. In a case of this type, an otherwise tax-free transaction became a taxable transaction, and if a second or lower tier foreign subsidiary was involved, the U.S. shareholders of the controlled foreign corporation might have been taxed under the subpart F rules. This could have occurred under the Service's section 367 guidelines despite the fact that a favorable ruling would clearly have been issued by the Internal Revenue Service had it been requested prior to the transaction.

The third area of difficulty in the administration of section 367 under prior law concerned situations where the IRS required a U.S. shareholder to include certain amounts in income as a toll charge even though there was no present tax avoidance purpose but, rather, only the existence of a potential for future tax avoidance. This occurred under the section 367 guidelines because of limitations in the carryover of attribution rules (sec. 381). The Internal Revenue Service in some cases had the option either of collecting an immediate tax or of collecting no tax at all since in those cases it had no authority to defer payment of the tax until the time that the avoidance actually arose, except by entering into closing agreement with the taxpayer.

The fourth problem concerned the fact that since the law required the satisfaction of the Commissioner, a taxpayer was unable to go through with a transaction and litigate in the courts the question of whether tax avoidance was one of the purposes of the transaction. While the Congress generally approves the standard applied by the IRS, there may have been cases where these standards were inappropriate or were not being correctly applied. Congress believes it is fair to permit taxpayers to litigate these questions in the courts.

The Congress further believes that the interpretation of the rules governing exchanges described in section 367 should not be done in individual rulings but should be provided by clear and certain regulations. While it is recognized that the prior rules were necessarily highly technical and largely procedural and while it is essential to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings, unnecessary barriers to justifiable and legitimate business transactions should be avoided. The Congress believes that U.S. taxpayers participating in certain types of transactions involving foreign corporations should be able to determine the tax effects of the transaction from the statute and accompanying regulations rather than being required to apply to the Internal Revenue Service for a determination in advance of the transaction. Only in those types of transactions where the amount of tax, if any, which must be paid to protect against tax avoidance can only be determined by judging the specific facts of the case should the taxpayer be required to obtain a determination from the Internal Revenue Service. Moreover, in cases where such a ruling is to be required, taxpayers should be permitted to obtain the ruling within some limited time after the transaction has begun.

A problem also existed with the provision which imposes a tax at ordinary income rates to the extent of post-1962 accumulated earnings and profits upon certain sales or exchanges of stock in a controlled foreign corporation (sec. 1248). In some situations other than those covered by section 367, a domestic corporation is entitled to nonrecognition of any gain if it sells, exchanges, or distributes its property. When transactions coming within the scope of these nonrecognition provisions involve the sale or distribution of stock in a controlled foreign corporation, section 1248 did not apply since that provision applied only when gain was recognized. Thus, any ordinary income tax on the repatriation of accumulated earnings and profits of the controlled foreign corporation was lost. For example, a U.S. parent corporation was able to avoid ordinary income tax on foreign earnings if it sold the stock in a controlled foreign subsidiary as part of a plan of complete liquidation (pursuant to sec. 337). The U.S. corporation was entitled to nonrecognition of gain (or loss) on the sale or exchange of the stock and was not required to recognize any gain when it distributed its property (including the sales proceeds) to its shareholders in complete liquidation. The shareholders would pay a capital gains tax on the difference between the value of the property received in liquidation and their basis in the stock of the liquidating corporation, but no ordinary income tax was paid on the foreign earnings.

A similar problem was involved, for example, if a U.S. corporation distributed stock in a controlled foreign corporation as a dividend. The distributing corporation would not recognize gain on the distribution and the distributee shareholders (if they were individuals) would acquire a fair market value basis in the distributed stock and would not be treated as holding the stock for the period it was held by the corporation (sec. 1223). Thus, although the shareholders would be taxed on the dividend out of the domestic corporation's earnings, there was no corporate tax on the earnings of the foreign corporation.

The Congress believed that the availability of nonrecognition treatment for distributions or exchanges of stock of controlled foreign corporations in situations not covered under section 367 or 1248 detracted substantially from the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation. In Congress's view, nonrecognition should not be available to the selling or distributing corporation but, rather, it should be required to include in income, as a dividend, its share of post-1962 foreign earnings and profits.

Explanation of provisions

The Act approaches the problems outlined above first by amending section 367 to establish separate rules for two different groups of transactions: (i) transfers of property from the United States, and (ii) other transfers (this latter group including transfers into the United States and those which are exclusively foreign). Transactions in the first group generally include those transactions where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale, while transactions in the second group include those where the statutory purpose in most cases is to prepare for taxation the accumulated profits of controlled foreign corporations.

Transfers from the United States.—With respect to the first group (sec. 367(a)), it is provided that if in connection with an exchange described in section 332, 351, 354, 355, 356, or 361, there is a transfer of property (other than stock or securities of a foreign corporation which is a party to the exchange) by a U.S. person to a foreign corporation, the foreign corporation will not be considered a corporation (for purposes of determining gain) unless, pursuant to a request filed not later than the close of the 183rd day after the beginning of the transfer, the taxpayer establishes to the satisfaction of the Internal Revenue Service that the exchange did not have as one of its principal purposes the avoidance of Federal income taxes. The term "party to the exchange" as used in this provision includes a party to the reorganization (as defined in sec. 368(b)) and the transferor and transferee in an exchange other than a reorganization. Types of "outbound" transfers falling within this category include exchanges involving transfers of property to a foreign corporation, the liquidation of a U.S. subsidiary into a foreign parent, the acquisition of a U.S. corporation's assets by a foreign corporation in a qualified reorganization and the acquisition of stock in a U.S. corporation by a foreign corporation in a type "B" reorganization.[3] Exchanges where the only transfer of property out of the United States is stock of a foreign corporation which is a party to the exchange are treated as transfers into the United States, since the principal concern in that case is the avoidance of taxation on the accumulated earnings of the foreign corporation. The rules for outbound transactions apply only to transfers of property by U.S. persons; they do not apply to transfers which are between two foreign corporations or between a foreign corporation and a foreign individual.

The Act thus provides that for transfers of property out of the United States the requirement of an advance ruling is replaced by a requirement that the taxpayer file a request for clearance with the

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[1] Also included as "outbound" transfers are transfers of assets from one domestic corporation to another in a "C" reorganization where the acquiring corporation is controlled by foreigners who were not in control of the acquired corporation before the reorganization.

Internal Revenue Service within 183 days after the beginning of the transfer. Even this post-transaction clearance from the Internal Revenue Service may not be required in certain clearcut situations involving outbound transfers where significant tax avoidance possibilities do not exist or where the amount of any section 367 toll charge can be ascertained without a ruling request. The Act provides that the Secretary is to designate by regulations those transactions which for these reasons do not require the filing of a ruling request. For transactions designated by the regulations, taxpayers may go ahead with the transaction without a ruling but are subject to any section 367 toll charge prescribed by the regulations. For example, if a section 351 transfer to a foreign corporation involves only the transfer of cash and inventory property, the Secretary may by regulations designate the transaction as one which does not require the filing of a request, although the regulations would require the inventory to be taken into income.

The Act provides a special rule dealing with the situation where there are a number of transfers which are treated by the Secretary as part of the same exchange. In general, if there is an organization, reorganization, or liquidation involving a transfer or transfers of property by a U.S. person to a foreign corporation, nonrecognition of gain will be permitted if a request for a ruling that a tax avoidance purpose is not present is filed within 183 days after the beginning of the transfer. Under this rule, the taxpayer may request a ruling not later than the 183rd day after the beginning of any transfer which is part of the exchange, whether or not a ruling has been requested with respect to prior transfers which are part of the exchange. If the Secretary determines that the entire exchange does not involve a tax avoidance purpose, nonrecognition of gain will be permitted for that transfer and any subsequent transfers. Nonrecognition will be provided with respect to any transfer which is part of the exchange but which begins more than 183 days before the ruling request is made if the Secretary determines that tax avoidance will not result if the earlier transfer is provided nonrecognition treatment and if a ruling was obtained for the earlier transfer. If no ruling was obtained for the earlier transfer, nonrecognition treatment will not be accorded the earlier transfer if a ruling is required for that transfer for there to be nonrecognition. However, failure of the taxpayer to apply for a ruling with respect to an earlier transfer will not automatically result in taxable treatment of the earlier transfer because the Secretary may require nonrecognition treatment of the earlier transfer in those situations he deems appropriate even in the absence of a ruling.

Tax Court review.—In the case of an actual controversy involving a determination or a failure to make a determination by the Secretary as to whether a plan has as one of its principal purposes the avoidance of Federal income taxes, the Act provides that a taxpayer may litigate the determination in the Tax Court. The Act generally follows the declaratory judgment procedures which were added to the tax law in the recently enacted pension reform act. In addition, the Tax Court is to review any terms and conditions which the Secretary seeks to impose upon a taxpayer in making the determination that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of income taxes.

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The Tax Court is to review whether the Secretary's determination as to tax avoidance is reasonable and whether the conditions imposed in making the determinations are reasonable conditions in order to prevent the avoidance of income tax. If the Tax Court finds that the Secretary's terms and conditions are not reasonable, then the Tax Court is to make a declaration as to the terms and conditions which it finds to be reasonable in order to prevent the avoidance of income taxes.

A request for a declaratory judgment under these proceedings can only be filed by a petitioner who is a transferor or transferee of stock, securities or property in an exchange where money or other property is being transferred from the United States (sec. 367(a)(1)). In addition, no proceeding may begin unless the exchange with respect to which the declaration is being sought has begun. It is not necessary for this purpose that the full exchange has been completed. In addition, this requirement will be satisfied although the taxpayer has transferred assets conditioned upon a stipulation that, if there is a failure to obtain from the Internal Revenue Service a determination that the transaction does not have as one of its principal purposes the avoidance of Federal income taxes, the transaction will not be completely consummated and, to the extent possible, the assets transferred will be returned.

Any such declaration is to have the force and effect of a final judgment or decree and is to be reviewable as such. The court is to base its determination upon the reasons provided by the Internal Revenue Service in its notice to the party making the request for a determination, or upon any new matter which the Service may wish to introduce at the time of the trial. The Tax Court judgment, however, is to be based upon a redetermination of the Internal Revenue Service's determination. The burden of proof rules are to be developed by the Tax Court under its rule-making powers. Under the existing Tax Court rules the taxpayer has the burden of proof as to matters in the notice of deficiency. As to matters raised by the Service at the time of the Tax Court hearing, the Service has the burden. It is expected that rules similar to these will be adopted by the Tax Court.

The judgment of the Tax Court in a declaratory judgment proceeding is to be binding upon the parties to the case based upon the facts as presented to the court in the case for the year or years involved. This, of course, does not foreclose action (within the limits of the legal doctrines of estoppel and stare decisis) if an examination of the facts of the exchange indicates that they differ from those stated in the ruling. It is anticipated that the normal rules of the Federal courts as they relate to declaratory judgment procedure will apply.

For a petitioner to receive a declaratory judgment from the Tax Court under this provision, he must demonstrate to the court that he has exhausted all administrative remedies which are available to him within the Internal Revenue Service. Thus, he must demonstrate that he has made a request to the Internal Revenue Service for a determination and that the Internal Revenue Service has either failed to act, or has acted adversely to him, and that he has appealed any adverse determination. To exhaust his administrative remedies a party must satisfy all procedural requirements of the Service. For example, the Service may decline to make a determination if a petitioner fails to supply the Service with the necessary information on which to make a determination.

A petitioner is not to be deemed to have exhausted his administrative remedies in cases where there is a failure by the Internal Revenue Service to make a determination before the expiration of 270 days after the request for such a determination is made. Once this 270-day period has elapsed, a petitioner who has exhausted his remedies may bring an action even though there has been no notice of determination from the Internal Revenue Service.

No petition to the Tax Court may be filed after 90 days from the date on which the Internal Revenue Service sends by certified or registered mail notice to a person of its determination (including refusals to make determinations) as to whether there is a tax avoidance purpose in an exchange. Such notice is to be treated by the taxpayer as exhaustion of administrative remedies. This 90-day period does not begin to run until the Secretary sends the taxpayer the required notice.

Tax Court Commissioners.—In order to provide the court with flexibility in carrying out this provision, the Act authorizes the Chief Judge of the Tax Court to assign the Commissioners of the Tax Court to hear and make determinations with respect to petitions for a declaratory judgment, subject to such conditions and review as the court may provide. Congress does not intend that this be construed as indicating that all of these proceedings should be heard by commissioners and decisions entered by them rather than by the judges of the court. Instead, it is intended to provide more flexibility to the Tax Court in the use of commissioners in these types of cases. It is anticipated, for example, that if the volume of these cases should be large, the Tax Court will expedite the resolution of these cases by authorizing commissioners to hear and enter decisions in cases where similar issues have already been heard and decided by the judges of the court or in other cases where, in the discretion of the court, it is appropriate for the commissioners to hear and decide cases.

These procedures apply with respect to proceedings filed with the Tax Court after the date of the enactment of the Act, but only with respect to transfers beginning after October 9, 1975.

Other transfers.—The Act establishes separate treatment under section 367(b) for a second group of transfers which consists of exchanges described in sections 332, 351, 354, 355, 356, and 361 that are not treated as transfers out of the United States (under section 367(a)) under the rules described above. With respect to these other transactions, a ruling is not required. Instead, a foreign corporation will not be treated as a corporation to the extent that the Secretary of the Treasury provides in regulations that are necessary or appropriate to prevent the avoidance of Federal income taxes. These regulations are to be subject to normal court review as to whether the regulations are necessary or appropriate for the prevention of avoidance of Federal income taxes. Thus, a taxpayer may challenge a proposed deficiency with respect to an exchange dealt with in the regulations by arguing in the courts that the regulations, as applied in the taxpayer's case, are not necessary or appropriate to prevent the avoidance of Federal income taxes. If the court should agree with the taxpayer, it is to apply the balance of the regulations to the extent appropriate.

Transfers covered in these regulations are to include transfers constituting a repatriation of foreign earnings. Also included are transfers that involve solely foreign corporations and shareholders (and involve a U.S. tax liability of U.S. shareholders only to the extent of determining the amount of any deemed distribution under the subpart F rules). It is anticipated that in this latter group of exchanges, the regulations will not provide for any immediate U.S. tax liability but will mai' tain the potential tax liability of the U.S. shareholder.

It is intended that the regulations promulgated with respect to this group of transactions will enable taxpayers to determine the extent (if any) to which there will be any immediate U.S. tax liability resulting from any transaction. The Act provides (sec. 367(b)(2)) that the regulations promulgated with respect to this group will include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a U.S. person, including regulations providing the circumstances under which (i) gain is recognized currently or is included in income as a dividend, or both, or (ii) gain or other amounts may be deferred for inclusion in the gross income of a shareholder (or his successor in interest) at a later date. The regulations may also provide the extent to which adjustments are to be made to the earnings and profits of any corporation, the basis of any stock or securities, and the basis of any assets.

Examples of transfers into the United States which are to be treated within this group (sec. 367(b)(1)) include: (i) the liquidation of a foreign corporation into a domestic parent; (ii) the acquisition of assets of a foreign corporation by a domestic corporation in a type "C" or "D" reorganization; and (iii) the acquisition of stock in a foreign corporation by a domestic corporation in a type "B" reorganization. With respect to transfers which exclusively involve foreign parties (i.e., where no U.S. persons are parties to the exchange), examples of situations coming within section 367(b)(1) include: (i) the acquisition of stock of a controlled foreign corporation by another foreign corporation; (ii) the acquisition of stock of a controlled foreign corporation by another foreign corporation which is controlled by the same U.S. shareholders as the acquired corporation; (iii) the acquisition of the assets of a controlled foreign corporation by another foreign corporation; (iv) the mere recapitalization of a foreign corporation (type "E" reorganization); and (v) a transfer of property by one controlled foreign corporation to its foreign subsidiary. For these exclusively foreign transactions, it is anticipated that regulations will provide for no immediate U.S. tax liability.

The Secretary's authority to prescribe regulations relating to the sale or exchange of stock in a foreign corporation includes authority to establish rules pursuant to which an exchange of stock in a second tier foreign corporation for other stock in a similar foreign corporation will result in a deferral of the toll charge which otherwise would be imposed based on accumulated earnings and profits. This deferral could be accomplished by designating the stock received as stock with a deferred tax potential in a manner similar to section 1248 without reference to the December 31, 1962, date; the amount includable as foreign source dividend income upon the subsequent disposition of the stock in question results in dividend income only to the extent of the gain realized on the subsequent sale or exchange. In addition, if a second tier foreign subsidiary is liquidated into a first tier foreign subsidiary, the regulations may provide that the tax which would otherwise be due in the absence of a ruling[2] is deferred until the disposition of the stock in the first tier foreign subsidiary.

Transfers treated as exchanges.—A distribution of stock or securities (under section 355) is treated as an exchange whether or not it otherwise would be an exchange. Also, a transfer of property to a foreign corporation in the form of a contribution of capital by one or more persons having (after application of the ownership attribution rules of section 318) at least 80 percent of the total combined voting power of all classes of stock entitled to vote is treated as an exchange of the property contributed to the corporation in return for the equivalent value of stock of the corporation.

Transitional rules.—The changes made to section 367 generally apply to transfers within the meaning of section 367, beginning after October 9, 1975. However, in order to permit the Internal Revenue Service sufficient time to develop the regulations required for transfers into the United States and between foreign corporations, the Act establishes a transition rule requiring that these regulations need not be effective until January 1, 1978. In the intervening period transactions which would otherwise be covered by those regulations are covered by the rules applicable generally to transfers out of the United States, and thus a ruling will be required. Moreover, in the case of any exchange (as described in section 367 as in effect on December 31, 1974), in any taxable year beginning after 1962 and before 1976, which does not involve the transfer of property to or from a U.S. person, a taxpayer has for purposes of section 367 until 183 days after the date of the enactment of this Act to make a request to the Secretary for a finding that such exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes so that for purposes of that section a foreign corporation is to be treated as a foreign corporation.

Sales or exchanges giving rise to dividends.—In addition to the above changes in section 367, the Act amends the provision which requires that recognized gain on the sale or exchange of stock in a foreign corporation be taxed as a dividend to the extent of earnings and profits of the foreign corporation. The Act applies this provision to situations where gain is not recognized under the provisions of sections 311, 336, and 337. The Act provides (in a new sec. 1248(f)) that if a domestic corporation which meets the stock ownership requirements of section 1248(a)(2) with respect to a foreign corporation distributes, sells, or exchanges the stock of the foreign corporation in a transaction to which section 311, 336, or 337 applies, then, notwithstanding any other provision, the domestic corporation is to include in gross income as a dividend an amount equal to the excess of the fair market value of the stock of the foreign corporation over its

[2] See Rev. Rul. 64–157, 1964—1 (Part 1) Cum. Bull. 139.

basis to the extent of the earnings and profits of the foreign corporation which were accumulated after 1962 and during the period the stock was held by the domestic corporation while the foreign corporation was a controlled foreign corporation. For this purpose earnings and profits excluded from the dividend treatment (of sec. 1248(a)) are not taken into account. Thus, earnings and profits of a less developed country corporation (to the extent provided in sec. 1248(d)(3)) are not taken into account.

If, however, the domestic corporation distributes the stock of a foreign corporation to a shareholder which is a domestic corporation the rule stated above generally does not apply since the basis of the property received is the lesser of fair market value or adjusted basis to the distributing corporation. In this type of situation, the corporate distributee does not receive a stepped up basis as a result of the distribution. Since the potential for the future application of section 1248 still exists, it is not necessary to override the nonrecognition provisions which otherwise apply to corporate distributions. Consequently, the Act provides that the distributing corporation need not include any amounts in income if the distribution is to a domestic corporation (i) which is treated as holding the stock for the period the stock was held by distributing corporation (sec. 1223): and (ii) which, immediately after the distribution, satisfies the stock ownership requirements of section 1248(a)(2) with respect to the foreign corporation.

The above rules also do not apply to certain section 337 liquidations of domestic corporations where, under prior law, gain was subject to tax as ordinary income to the shareholders of that corporation under the provisions of section 1248(e) dealing with domestic corporations formed or availed of to hold stock of a foreign corporation. This exception applies if (1) all the stock of a domestic corporation is owned by United States persons who have been 10 percent shareholders of the domestic corporation throughout the entire period that the stock of the foreign corporation was held by the domestic corporation, and (2) the provisions of section 1248(a) treating an amount equal to the earnings of the foreign corporation as a dividend apply by reason of section 1248(e)(1) to any liquidation or distribution from the domestic corporation and applied to all other transactions relating to the stock of the domestic corporation during the period that the domestic corporation held the stock of the foreign corporation.

Also the rules for taxing the sale of a partnership interest (under sec. 751) are modified so that to the extent any gain from the sale is attributable to stock in a controlled foreign corporation, that gain is to be treated as ordinary income (in the same manner as gain attributable to section 1245 property and section 1250 property is taxed as ordinary income).

Effective date

The modifications to section 367 and to section 1248 and related provisions apply to transfers beginning after October 9, 1975, and to sales, exchanges, and distributions taking place after that date.

Revenue effect

It is not expected that these provisions will have any significant impact on the revenues.

8. Contiguous Country Branches of Domestic Insurance Companies (sec. 1043 of the bill and sec. 819A of the Code)

Prior law

Under prior law, a domestic life insurance company was subject to tax on its worldwide taxable income. If the company paid foreign income taxes on its income from foreign sources it was allowed a foreign tax credit against its otherwise payable U.S. tax on foreign source income.

Reasons for change

Since the beginning of this century, U.S. mutual life insurance companies have been engaged in the life insurance business in Canada. Under prior law, the tax imposed by the United States on the operations of Canadian branches of U.S. mutual life insurance companies generally exceeded the tax imposed by the Dominion of Canada and its provinces.

The income of the companies from their Canadian operations is derived generally by the issuance of policies insuring Canadian risks and the investment income from the policyholder reserves on the Canadian risks and any surplus. Quite often the investments of the Canadian branch is in Canadian securities. A separate branch account is maintained by the life insurance companies under which the various income, expense, asset, reserve and other items that relate to Canadian policyholders are segregated on the books of the company. The separate branch accounting system is used for purposes of establishing premiums and policyholder dividend rates based upon the separate mortality and earnings experience of the Canadian branch.

The income earned by the Canadian branch inures solely to the benefit of these Canadian policyholders and is reflected either by dividends paid to them or increases in the size of the reserves and surplus with respect to Canadian policyholders. Thus, the additional cost resulting because U.S. tax liability exceeded Canadian income tax liability on the Canadian branch profits fell primarily upon the Canadian policyholders, since it reduced the reserves and surplus available to the Canadian policyholders. This additional cost made it more difficult to issue mutual life insurance policies in Canada.

Further, under prior law the sale of pension contracts in Canada had been almost precluded by uncertainty as to whether reserves for Canadian pension contracts qualified for the exclusion from gross income which reserves for qualified plans in the United States may obtain.

In contrast, Canada, which generally also taxes Canadian companies on their worldwide taxable income, does not tax Canadian life insurance companies on their foreign source income except when the profits are repatriated.

As a general rule, profits of a U.S. company although earned from sources outside the United States should be subject to U.S. tax when earned since those profits are available for distribution to the shareholders of the company or are available to the company to be used within or without the United States for new investments. However, the profits derived by a Canadian branch of a U.S. mutual life insurance company are not generally available for use other than as reserves and surplus for the Canadian policyholders and may not be used to provide insurance for the U.S. policyholders. This unique feature of mutuality, in which the earnings are restricted to benefit the Canadian policyholders, distinguishes the branch operations of a mutual life insurance company from the branch operations of other businesses. For this reason Congress believes it is appropriate to view the Canadian operation as a separate entity in effect owned by the Canadian policyholders. Accordingly, Congress concluded that it was desirable to provide that the profits of the Canadian branch of a U.S. mutual life insurance company are not to be subject to U.S. taxation except in the rare situation where profits are somehow repatriated to the United States for the benefit of the non-Canadian operations or are derived from sources within the United States.

Congress concluded that it would also be desirable to provide a special rule in the case of stock life insurance companies operating in Canada or Mexico. While it is easier for a stock life insurance company to operate through a subsidiary organized under foreign law than it is for a mutual company, problems would be encountered in transferring an existing business to a foreign subsidiary since such a transfer would require the satisfaction of the Secretary that one of its purposes was not the avoidance of Federal income taxes. Since the Act contains special rules for deemed transfers in the case of mutual life insurance companies, Congress felt it was appropriate to provide similar rules in the case of actual transfers by stock companies to a contiguous country subsidiary.

Explanation of provisions

Mutual companies.—The Act establishes a special system of taxation for branches of U.S. mutual life insurance companies which are operated in a contiguous country (i.e., Canada or Mexico). To be eligible for this special treatment a mutual life insurance company must make an election with respect to a contiguous country life insurance branch.

If a proper election is made, there is excluded from each item involved in the determination of life insurance company taxable income the items separately accounted for in a separate contiguous country branch account which the mutual life insurance company is required to establish and maintain under the Act. The branch account must be established by the end of the first taxable year to which the election applies and is to include the various items of income, exclusion, deduction, asset reserve, liability, and surplus properly attributable to life insurance contracts issued by the contiguous country branch. The separate accounting is to be made in accordance with the method regularly employed by the company, if the method clearly reflects income derived from, and other items attributable to, the life insurance contracts issued by the contiguous country branch, and in all other cases in accordance with regulations issued by the Secretary. Once a method of branch accounting is established, it must be applied consistently and may not be changed. However, the taxpayer may initially choose in his return for the first taxable year to which it applies the system of branch accounting which properly reflects the results of operations of the branch. It is expected that the regulations will provide that a system properly reflects income if it provides for an allocation or designation of assets to the contiguous country branch at the time that they are acquired. This requirement is satisfied if the allocation or designation is made on a periodic basis (either monthly or weekly). Once an asset is designated or allocated as a branch asset it must retain that character so long as it is held. All income, expense, gain or loss connected with a branch asset must be accounted for in the branch account. Also, new assets acquired by the company must be credited to the branch account to the extent attributable to reserves and surplus in the branch account.

For purposes of this provision, a branch is a contiguous country life insurance branch if it satisfies three conditions. First, it must issue insurance contracts insuring risks in connection with the lives or health of residents of a country which is contiguous to the United States (i.e., Canada or Mexico). For this purpose an insurance contract means any life, health, accident, or annuity contract or reinsurance contract with respect to these contracts or any other type of contract relating to these contracts. Second, the branch must have its principal place of business in the contiguous country for which it insures risks. Third, the branch, if it were a separate domestic corporation, must be able to qualify as a separate mutual life insurance company.

The Act provides that an election to establish a separate contiguous country branch is to be treated as a taxable disposition for purposes of recognizing any gain by the domestic company. If the aggregate fair market value of all the invested assets and tangible property which is separately accounted for by the company in the branch account exceeds the aggregate adjusted basis of those assets (for purposes of determining gain), then the company is to be treated as having sold those assets on the first day of the first taxable year for which the election is in effect at the fair market value on that day. The net gain on the deemed sale of these assets is to be recognized notwithstanding any other provision of the Code. The assets taken into account for this determination include all of the invested assets (such as stock and securities) and all tangible property (such as land, buildings, and equipment) which are separately accounted for in the branch account. However, goodwill, since it is an intangible asset, is not taken into account.

While Congress does not believe that any of the profits of the contiguous country branch can be accumulated for the benefit of the U.S. policyholders (since the branch is treated as operating as a mutual life insurance company and insures risk for policyholders only in a contiguous country and thus any profits would be accumulated for the benefit of the contiguous country policyholders), the Act nevertheless, in order to provide assurance on this point, provides rules for the taxation of the contiguous country branch income if it is ever repatriated. First, payments, transfers, reimbursements, credits, or allowances which are made from a separate contiguous country branch account to one or more accounts of the domestic company as reimbursements for costs (e.g., home office services) incurred for or with respect to the insurance (including reinsurance) of risks accounted for in the separate branch account are to be taken into account by the domestic company in the same manner as if the payment, transfer, reimbursement, credit, or allowance were received from a separate person. For this purpose the rules in the Internal Revenue Code (sec.

482) dealing with reimbursement of costs between related parties are to apply and the domestic company is to establish procedures for billing the branch at cost. Reimbursements under this provision are not treated as repatriation of income.

If amounts are directly or indirectly transferred or credited from a contiguous country branch account to one or more other accounts of the domestic company they are to be added to the life insurance company taxable income of the domestic company except to the extent the transfers are reimbursements for home office services. The amount which is to be added to life insurance company taxable income is not to exceed the amount by which the aggregate decrease in life insurance company taxable income for the taxable year and for all prior taxable years resulting solely from the application of these exclusion provisions with respect to the contiguous country branch exceeds the amount of additions to life insurance company taxable income with respect to that branch which were treated as a repatriation of income for all prior taxable years.

The Act provides that no foreign tax credit (under secs. 901 or 902) is to be allowed with respect to income excluded from life insurance company taxable income by reason of it being accounted for in a contiguous country life insurance branch. In addition, no deduction is to be allowed for these amounts. If amounts are treated as repatriated from a contiguous country life insurance branch, they are to be treated for purposes of the foreign tax credit provisions (secs. 78 and 902) as if they were paid as a dividend from a foreign subsidiary. Thus, the gross-up provisions of section 78 are to apply. For purposes of taxation of any income from U.S. sources which is earned by the contiguous country life insurance branch, the branch is treated as a foreign corporation and is subject to tax under the provisions of sections 881, 882 and 1442. Thus, if it derives fixed or determinable annual or periodic income from the United States it is subject to the withholding taxes which apply to foreign corporations. For this purpose a Canadian branch is to be entitled to any treaty benefits which it would be entitled to if it were a Canadian subsidiary of a U.S. corporation.

The election provided by this provision may be made for any taxable year beginning after December 31, 1975. Once an election is made, it is to remain in effect for all subsequent years except that it may be revoked with the consent of the Secretary. An election, however, may not be made later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year with respect to which the election is made. Elections and any revocations are to be made in a manner prescribed by the Secretary.

Transfer by stock companies.—Under the Act, a domestic stock life insurance company which has a contiguous country life insurance branch may elect to transfer the assets of that branch to a foreign corporation organized under the laws of that contiguous country without the application of section 367 or 1491. Thus, the excise tax under section 1491 is not to be imposed on the transfer, nor is the Commissioner's approval of the transfer required under section 367.

The insurance contracts which may be transferred to the subsidiary include only those of the types issued by a mutual life insurance company. For this purpose an insurance contract means a life, health, accident or annuity contract or reinsurance contract with respect to these contracts and other types of contracts relating to such contracts. Contracts are to be considered as similar to those issued by a mutual life insurance company if they provide to the policyholder a reduction in premiums similar to the mutual life insurance company's dividend or retrospective rate credit.

The Act provides for the taxation of the net gain on the transfer. To the extent that the aggregate fair market value of all the invested assets in tangible property which are separately accounted for in the contiguous country life insurance branch exceeds the aggregate adjusted basis of all of these assets for purposes of determining gain, the domestic life insurance company is to be treated as having sold all of the assets on the first day of the first taxable year for which the election is in effect. The sale will be deemed to have been at the fair market value on that first day, and notwithstanding any other provision of Chapter 1 (e.g., sec. 351), the net gain is to be recognized to the domestic life insurance company on the deemed sale. If less than all of the invested assets and tangible property of the contiguous country life insurance branch of the domestic company are transferred, the domestic company will recognize only that part of the net gain which is proportional to the total net gain as the value of the transferred assets is to the value of all such assets.

This provision also provides that the stock of the subsidiary for purposes of determining the income tax of the domestic stock life insurance company is to be given the same treatment as is accorded the assets of a contiguous country branch of a mutual company under the mutual company provision. Similarly, any dividends paid by the subsidiary to the domestic life insurance company will be added to its life insurance company taxable income.

Effective date

The provisions of this section apply to taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that the mutual and stock company provisions will result in a decrease in budget receipts of $12 million in fiscal year 1977 and of $8 million thereafter.

9. Transitional Rule for Bond, Etc., Losses of Foreign Banks (sec. 1044 of the Act and sec. 582(c) of the Code)

Prior law

The Tax Reform Act of 1969 (Public Law 91–172) eliminated the preferential treatment accorded to certain financial institutions for transactions involving corporate and government bonds and other evidences of indebtedness. Previous to that these financial institutions were allowed to treat net gains from these transactions as capital gains and to deduct the losses as ordinary losses. The 1969 Act (sec. 433, amending sec. 582 of the Code) provided parallel treatment to gains and losses pertaining to these transactions by treating net gains as ordinary income and by continuing the treatment of net losses as ordinary losses. The ordinary income and loss treatment provided under the 1969 Act was also applied to corporations which would be considered banks except for the fact that they are foreign corporations. Previous to the 1969 Act, these corporations had treated the above-described transactions as resulting in either capital gains or capital losses.

Reasons for change

Some of the corporations which would be considered banks except for the fact that they are foreign corporations had capital loss carryovers predating the 1969 Act. However, any post-1969 gains realized by these corporations resulting from the sale or exchange of a bond, debenture, note, or other evidence of indebtedness were accorded ordinary income treatment. Thus, these corporations were left with capital loss carryforwards which, under prior law, could not be applied against any gains resulting from the same type of transactions which had previously generated such losses.

Explanation of provision

The Act provides a special transitional rule for corporations which would be banks except for the fact that they are foreign corporations. Under the Act, net gains (if any) for a taxable year on sales or exchanges of bonds, debentures, notes, or other evidences of indebtedness are considered as gains from the sale or exchange of capital assets to the extent that such gains do not exceed the portion of any capital loss carryover to the taxable year where such capital loss is attributable to the same types of sales or exchanges for taxable years beginning before July 12, 1969. In addition, the Act provides that the refund or credit of any overpayment as a result of its application is not precluded by the operation of any law or rule of law (other than section 7122, relating to compromises) so long as the claim for credit or refund is filed within one year after the date of the enactment of the Act.

Effective date

The provision applies to taxable years beginning after July 11, 1969.

Revenue effect

The revenue loss for fiscal 1977 is estimated to be less than $5 million.

10. Tax Treatment of Corporations Conducting Trade or Business in Possessions of the United States (sec. 1051 of the Act and secs. 33, 931, and 936 of the Code)

Prior law

Under prior law, corporations operating a trade or business in a possession of the United States were entitled to exclude from gross income all income from sources without the United States, including foreign source income earned outside of the possession in which they conducted business operations, if they met two conditions. First, 80 percent or more of the gross income of the corporation for the 3-year period immediately preceding the close of the taxable year had to be derived from sources within a possession of the United States. Second, 50 percent of the gross income of the corporation for the same 3-year period had to be derived from the active conduct of a trade or business within a possession of the United States.

Any dividends from a corporation which satisfied these requirements were not eligible for the intercorporate dividends received deduction (sec. 246(a)(2)(B)). In addition, since corporations meeting the requirements of section 931 were domestic corporations, no gain or loss was recognized by a parent corporation if it liquidated a possessions corporation (under sec. 332). Corporations satisfying the requirements of a possessions corporation and receiving some benefit from the exclusion of income were not entitled to be included in the consolidated return of an affiliated group of corporations (sec. 1504(b)(4)).

The exclusion of possession income applied to corporations conducting business operations in the Commonwealth of Puerto Rico and all possessions of the United States except the Virgin Islands. The exclusion also applied to business operations of U.S. citizens in possessions other than Puerto Rico, the Virgin Islands, and Guam.

Reasons for change

The special exemption provided (under sec. 931) in conjunction with investment incentive programs established by possessions of the United States, especially the Commonwealth of Puerto Rico, have been used as an inducement to U.S. corporate investment in active trades and businesses in Puerto Rico and the possessions. Under these investment programs little or no tax is paid to the possession for a period as long as 10 to 15 years. Under prior law no tax was paid to the United States as long as no dividends were paid to the parent corporation.

Because no current U.S. tax was imposed on the earnings if they were not repatriated, the amount of income which accumulated over the years from these business activities could be substantial. The amounts allowed to accumulate were often beyond what could be profitably invested within the possession where the business was conducted. As a result, corporations generally invested this income in other possessions or in foreign countries either directly or through possessions banks or other financial institutions. In this way possessions corporations not only avoided U.S. tax on their earnings from businesses conducted in a possession, but also avoided U.S. tax on the income obtained from reinvesting their business earnings abroad.

After studying the problem, Congress concluded that it is inappropriate to disturb the existing relationship between the possessions investment incentives and the U.S. tax laws because of the important role it is believed they play in keeping investment in the possessions competitive with investment in neighboring countries. The U.S. Government imposes upon the possessions various requirements, such as minimum wage requirements [1] and requirements to use U.S. flag ships in transporting goods between the United States and various possessions,[2] which substantially increase the labor, transportation and other costs of establishing business operations in Puerto Rico. Thus, without significant local tax incentives that are not nullified by U.S. taxes, the possessions would find it quite difficult to attract investments by U.S. corporations.

However, investing the business earnings of these possessions corporations outside of the possession where the business is being conducted does not contribute significantly to the economy of that possession either by creating new jobs or by providing capital to others to acquire new plant and equipment. Accordingly, while Congress believes it is appropriate to continue to exempt trade or business income derived in a possession and investment income earned in that possession, it does not believe it is appropriate to provide a tax exemption for income from investments outside of the possession.

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[1] 29 U.S.C. 206–208.
[2] 46 U.S.C. 883.

In addition, Congress recognized that the provision of prior law denying a dividends received deduction to the U.S. parent corporation forced a possessions corporation to invest its income abroad until it was liquidated (usually upon the termination of the local tax exemption) when it could be returned to the United States tax free. These accumulated business profits were thus not available for investment within the United States, and the income produced was (under prior law) not subject to U.S. tax. Congress believed that while it is appropriate to tax the foreign source investment income from possession business earnings, possessions corporations should at the same time be given the alternative of returning the business income to the United States prior to liquidation without paying U.S. tax. Permitting tax-free repatriation of the accumulated earnings only upon the liquidation of the possessions corporation, while taxing the foreign source investment income derived from the accumulated earnings, would lessen to a significant extent the tax incentive of making the initial investment.

To accomplish these two major changes, the Act revises prior law to provide for a more efficient system for exemption of possessions corporations. Under the Act, these corporations are generally to be taxed on worldwide income in a manner similar to that applicable to any other U.S. corporation, but a full credit is to be given for the U.S. tax on the business and qualified investment income from possessions regardless of whether or not any tax is paid to the government of the possession. The effect of this revised treatment is to exempt from tax the income from business activities and qualified investments in the possessions, to allow a dividends received deduction for dividends from a possessions corporation to its U.S. parent corporation, and to tax currently all other foreign source income of possessions corporations (with allowance for the usual foreign tax credit for foreign taxes paid with respect to that other income). Congress believes that this revised treatment will assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations, while at the same time encouraging those corporations to bring back to the United States the earnings from these investments to the extent they cannot be reinvested productively in the possession.

A second set of difficulties under prior law resulted from the relationship of the possessions corporation provisions to the provisions relating to the filing of consolidated tax returns. Domestic corporations which are affiliated (i.e., generally where there is a common ownership of 80 percent or more of their stock) usually file a consolidated tax return. Among the benefits of a consolidated return is the opportunity to offset the losses of one corporation against the income of other corporations. A corporation which was entitled to the benefits of the special possessions corporation exclusion could not participate in the filing of a consolidated return. However, the courts determined that possessions corporations could join in filing consolidated returns in years in which they incur losses.[3] As a result, these corporations

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[3] The Internal Revenue Service had taken the position that a corporation which meets both of the gross income tests of the possession corporation exclusion provision may not file a consolidated return in years in which that corporation incurred a loss. However, the Tax Court in *Burke Concrete Accessories, Inc.*, 56 T.C. 588 (1971), held that the possession corporation was properly includable in the consolidated return in these years since it could not be entitled to any benefit from the exclusion provision where it had a loss year. The Internal Revenue Service reversed its position in light of this decision (Rev. Rul. 73–498, 1973–2 C.B. 316).

could in effect gain a double benefit. Not only was the possessions and other foreign source income of these corporations excluded from U.S. taxable income, but losses of possessions corporations could, by filing a consolidated return, reduce U.S. tax on the U.S. income of related corporations in the consolidated group. Congress believes that it is appropriate to allow the losses of a possession corporation to reduce U.S. tax on other income by filing a consolidated return only in the case of initial or start-up losses of possessions corporation just beginning its possession operations. Moreover, even in the case of start-up losses which offset U.S. source income Congress believes that these losses should be recaptured if in a later year foreign source income is derived.

Explanation of provisions

Accordingly, the Act provides that a possessions corporation must make an election to obtain the benefits of possessions corporation status and that after this election the corporation is ineligible to join in filing a consolidated return for a period of 10 years.[4] Once the election is made the losses of the possessions corporation cannot offset the income of other related corporations.

The Act achieves the results described above by adding a new provision (sec. 936 of the Code) for the tax treatment of U.S. corporations operating in Puerto Rico and possessions of the United States, other than the Virgin Islands. The provision of prior law (sec. 931 of the Code) is retained for citizens with business operations in possessions of the United States, other than the Virgin Islands, Guam, and Puerto Rico. The new provision establishes a new tax credit for certain income of possessions corporations. This tax credit (called the section 936 credit) is given in lieu of the ordinary foreign tax credit (provided in sec. 901 of the Code).

The Act provides that any domestic corporation which elects to be a section 936 corporation can receive the section 936 tax credit if it satisfies two conditions. First, 80 percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year must be from sources within a possession (or possessions). Second, 50 percent or more of its gross income must be derived from the active conduct of a trade or business within a possession (or possessions).

The amount of the credit allowed under this provision is to equal the portion of the U.S. tax on the domestic corporation attributable to taxable income from sources without the United States from the active conduct of a trade or business within a possession of the United States and from qualified possession source investment income. In determining the amount of tax attributable to the income from the active conduct of a possession trade or business or from qualified possession investment income, losses from other sources are to be taken into account. For example, if a corporation has an overall loss from foreign sources (not taking into account income qualifying for the section 936 tax credit), these losses reduce income from U.S. sources

[4] Unlike the act of incorporating a branch in a foreign jurisdiction, the making of a section 936 election does by itself cause a recapture of an earlier loss.

and income qualifying for the section 936 credit proportionately for purposes of determining the tax on the taxable income from which the section 936 credit is allowed.

Qualified possession source investment income includes only income from sources within a possession in which the possessions corporation actively conducts a trade or business (whether or not such business produces taxable income in that taxable year). It is intended that interest paid by one possessions corporation to a second unrelated possessions corporation operating in the same possession is to be treated as qualified possessions source investment income. Further, the taxpayer must establish to the satisfaction of the Secretary that the funds invested were derived from the active conduct of a trade or business within that same possession and were actually invested in assets in that possession. It is intended that income from sources within the possession attributable to reinvestments of qualified possession source investment income is also to be treated as qualified possessions source investment income. Funds placed with an intermediary (such as a bank located in the possession) are to be treated as invested in that possession only if it can be shown that the intermediary did not reinvest the funds outside the possession. The special treatment for qualified possessions source investment income is provided so that the possessions do not lose a significant source of capital which they presently have available to them for the financing of government development programs and private investment.

To avoid a double credit against U.S. taxes if a corporation is eligible for the section 936 credit, any actual taxes paid to a foreign country (because it has different source rules) or a possession with respect to the gross income taken into account for the credit are not treated as a creditable tax (under sec. 901 of the Code), and no deduction is to be allowed with respect to that tax. Thus, the section 936 credit replaces entirely any section 901 foreign tax credit and any deduction for taxes paid which otherwise would be allowed with respect to the income taken into account.

Since the new section 936 tax credit is separate from the tax credit permitted under section 901, the limitation under section 904 of the Code is not to apply to income subject to a section 936 credit, and such income is not to be taken into account in computing the limitation on the amount of allowable tax credits (under sec. 904 of the Code).[5]

The credit provided for under section 936 is generally to be allowed against taxes imposed by chapter 1 of the Internal Revenue Code. However, the credit is not to be taken against any minimum tax for tax preferences (sec. 56 of the Code), any tax on accumulated earnings (sec. 531 of the Code), taxes relating to recoveries of foreign expropriation losses (sec. 1351 of the Code), or the personal holding company tax (sec. 541 of the Code). In computing the amount of U.S. tax paid by the corporation which is attributable to possessions active trade or business and qualified investment income, taxes paid relating to the items described above are not taken into account.

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[5] Thus, the numerator and denominator of the limiting fraction (provided in sec. 904) are to be calculated without regard to the taxable income for which a credit is permitted under section 936.

In order to receive the benefits of the section 936 tax credit, a corporation must make an election at the time and in the manner as the Secretary prescribes by regulations. Once the election is made, the domestic corporation cannot join in a consolidated return with other related taxpayers. The election is to remain in effect for nine taxable years after the first year for which the election was effective and for which the domestic corporation satisfied the 80 percent possession source income and 50 percent active trade or business income requirements. However, the election may be revoked before the expiration of the 10-year period with the consent of the Secretary. It is contemplated that consent will be given only in cases of substantial hardship where no tax avoidance can result from the revocation of the election. In determining whether there would be substantial hardship, the Secretary is to take into account changes in business conditions. The election shall remain in effect after the 10-year period unless such domestic corporation revokes such election. After a revocation the domestic corporation may again make the election for a 10-year period in any taxable year in which it satisfies the 80 percent possession source income and 50 percent active trade or business tests.

The Act retains existing law by providing that any gross income actually received by a possessions corporation within the United States, whether or not that income is derived from sources within or without the United States, is not taken into account as income for which a section 936 tax credit may be allowed. However, this income may be eligible for a section 901 tax credit if any foreign taxes were paid on that income.

Finally, the Act provides for a dividends-received deduction (sec. 246(a)(1) of the Code) for dividends received from corporations eligible for the section 936 tax credit. Thus, corporations which otherwise would qualify for the 100-percent dividends-received deduction if an election (under sec. 936) were not in effect are to receive that deduction for dividends from a possessions corporation. Also, corporations eligible for the 85-percent dividends-received deduction are to receive that deduction with respect to dividends from possessions corporations. The amount of any income received as a dividend from a possessions corporation is to be domestic or foreign source income as determined under existing rules of the Code (sec. 861), and is to be included in the computation of the limitation on the section 901 foreign tax credit (sec. 904 of the Code).

Since the 100-percent dividends-received deduction totally eliminates any U.S. tax on dividends paid by a possessions corporation, and the 85 percent dividends-received deduction (after the allocation of expenses) will in many cases eliminate any U.S. tax on the dividend, the Act adds a provision disallowing a credit or a deduction for any income taxes paid to a possession or foreign country with respect to the repatriation of earnings. Further, the disallowance provision applies in the case of a tax-free liquidation of a possessions corporation.

It is the understanding of Congress that the Department of the Treasury is to review the operations of section 936 corporations in order to apprise Congress of the effects of the changes made by the Act. The Treasury is to submit an annual report to the Congress setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects to the provision as well as the effects on inevstment and employment in the possessions. These reports, which are to begin with a report for calendar year 1976, are to be submitted to the Congress within 18 months following the close of each calendar year.

Effective dates

The provisions of the Act establishing a new section 936 tax credit for certain possessions income apply to taxable years of possessions corporations beginning after December 31, 1975. The new rules on the dividends-received deduction apply to dividends paid in taxable years of possessions corporations beginning after that date regardless of when the earnings out of which the dividends were paid were accumulated.

Although these provisions generally apply to taxable years of possessions corporations beginning after December 31, 1975, the Act continues to exempt foreign source income derived from sources outside the possession by treating the investment income as qualified possession source investment income if the taxpayer can establish to the satisfaction of the Secretary that the income was earned before October 1, 1976, whether or not the invested funds were initally derived from the possessions business. Similarly, funds which are properly reinvested in the possession will produce qualified possession source investment income provided those funds had been derived initially from a trade or business conducted by the corporation in that possession. In addition, the foreign tax credit is allowed for taxes paid with respect to liquidations occurring before January 1, 1979, to the extent the taxes are attributable to amounts earned before January 1, 1976.

Revenue effect

It is estimated that these provisions will result in an increase budget receipts of $6 million in fiscal year 1977 and of $10 million thereafter.

11. Western Hemisphere Trade Corporations (sec. 1052 of the Act and secs. 921 and 922 of the Code)

Prior law

Under prior law, certain domestic corporations called "Western Hemisphere Trade Corporations" (WHTCs) were entitled to a deduction which could reduce their applicable corporate income tax rate by as much as 14 percentage points below the applicable rate for other domestic corporations.[1]

A domestic corporation had to meet three basic requirements to qualify as a WHTC. First, all of its business (other than incidental purchases) had to be conducted in countries in North, Central or South America or in the West Indies. Second, the corporation had to derive at least 95 percent of its gross income for the 3-year period immediately preceding the close of the taxable year from sources outside the United States. Third, at least 90 percent of the corporation's income for the above period had to be derived from the active conduct of a

[1] The deduction (sec. 922 of the Code) was equal to taxable income multiplied by 14 over the normal tax and surtax rates.

trade or business. The above requirements were intended to insure that the corporation was engaged in an active trade or business outside the United States, but within the Western Hemisphere.

Reasons for change

The WHTC provisions were originally enacted in 1942 during a period of high U.S. wartime taxes and generally low taxes in other Western Hemisphere countries. The provision was aimed at insuring that domestic corporations did not operate at a disadvantage in competing with foreign corporations within the Western Hemisphere. While not explicitly stated, it appears that the goal was to retain U.S. ownership of foreign investments, which if placed in a foreign corporation, might end up being owned by foreign interests.

Congress believes general tax equity requires that income derived from all foreign sources be taxed at the same rate. To the extent that incentives are needed for the export of U.S. manufactured goods Congress believes that the Domestic International Sale Corporation (DISC) provisions are a more appropriate incentive. Further, because the taxes imposed by other Western Hemisphere countries have been substantially increased since the original enactment of the provision, many companies which qualified as WHTCs received little or no benefit from the deduction. Thus, in many instances the WHTC deduction merely added to the complexity of preparing an income tax return without providing significant tax benefits.

The preferential rate granted to WHTCs also encouraged U.S. manufacturers to set the price on sales of goods to related WHTCs so as to maximize the income derived by the WHTCs since this income was taxed at the lower WHTC rate. These pricing practices have been the source of many controversies between taxpayers and the Internal Revenue Service. Finally, the broad interpretation given to the WHTC provisions by the Internal Revenue Service enabled corporations to obtain the benefits of the WHTC provisions for goods manufactured outside the Western Hemisphere by causing the title to the goods sold to the WHTC to be passed within the Western Hemisphere. In such a situation Congress believes it is inappropriate to give special tax relief.

Explanation of provision

The Act repeals the WHTC provisions for taxable years beginning after December 31, 1979. However, corporations which qualify for WHTC treatment are provided a transitional period in which they can adjust their operations to the repeal of the provisions. During this transitional period the 14-percent tax reduction (*i.e.*, the numerator in the 14/48ths fraction) is gradually phased out beginning in 1976. Under the phaseout rules the percentage rate reduction is reduced to 11 percent in 1976, 8 percent in 1977, 5 percent in 1978 and 2 percent in 1979. Corporations which presently do not qualify for WHTC treatment are able to qualify and receive the remaining benefits of the treatment during the transitional period. Thus, during the phaseout period no distinction is to be made between corporations qualifying for WHTC treatment in 1975 and other corporations which first qualify during the phaseout period. It is anticipated by the Congress that in appropriate situations the modifications made by the Act to section 367 will make it easier for certain WHTCs to adjust to the repeal of the WHTC provisions by reincorporating in a foreign country where they are doing business in order to retain tax advantages provided by the tax laws of foreign governments.

Effective date

The provision phasing out WHTC treatment applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision will increase budget receipts by $19 million in fiscal year 1977, $25 million in fiscal year 1978, and $50 million in fiscal year 1981.

12. China Trade Act Corporations (sec. 1053 of the Act and secs. 941 to 943 of the Code)

Prior law

Under prior law, China Trade Act Corporations ("CTA corporations") and their shareholders were entitled to special tax benefits. Under those provisions, a CTA corporation was subject to the same tax rates as any other domestic corporation, but, upon meeting certain requirements, was allowed a special deduction which could completely eliminate any income subject to tax (sec. 941).[1]

The special deduction was allowed against taxable income derived from sources within Formosa and Hong Kong in the proportion which the par value of stock held by residents of Formosa, Hong Kong, the United States, or by individual citizens of the United States, wherever resident, bore to the par value of all outstanding stock. Thus, where all the shareholders of the CTA corporation were either U.S. citizens or residents of Hong Kong, Formosa, or the United States, and all of the corporation's income was derived from sources within Hong Kong and Formosa, the special deduction equaled and thereby eliminated the taxable income of the corporation.

The special deduction was limited by a requirement that a dividend be paid in an amount at least equal to the amount of Federal tax that would have been due were it not for the special deduction. The "special dividend" had to be paid to stockholders who, on the last day of the taxable year, were resident in Formosa, Hong Kong, or were either residents or citizens of the United States.[2] The special dividend deduction enabled the CTA corporation to operate free of tax.

In addition to the favorable tax treatment at the corporate level, special benefits were accorded to the shareholders of a CTA corporation. Dividends paid by a CTA corporation to shareholders who resided in Hong Kong or Formosa were not includable in the gross income of the shareholder (sec. 943). This applied to all dividends paid to Hong Kong or Formosa resident shareholders, regardless of whether they were regular or special dividends.

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[1] The CTA corporation was not entitled to the foreign tax credit (sec. 942), but was entitled to the deduction of all foreign taxes paid with respect to taxable income derived from sources within Hong Kong or Formosa (sec. 164).

[2] For example, if the taxable income before the special deduction was $100,000, the special dividend would have to equal at least $41,500 (22 percent of the first $25,000 plus 48 percent of the remaining $75,000). In this example, upon payment of the special dividend of $41,500, the CTA corporation deriving all of its taxable income from sources within Hong Kong and Formosa ($100,000) would be entitled to a special deduction in an amount equal to its taxable income, i.e., $100,000.

Reasons for change

The combination of benefits granted to CTA corporations and their shareholders was unprecedented.[3] Both the corporation and its shareholders could operate free of any U.S. tax liability.

As originally enacted, the China Trade Act was intended to apply to mainland China, including Manchuria, Tibet, Mongolia, and any territory leased by China to any foreign government, the Crown Colony of Hong Kong, and the Province of Macao. However, since the early 1950's the provisions have only applied to business transactions by CTA corporations in Hong Kong and Formosa.

Since the enactment of the China Trade Act of 1922, Sino-U.S. trade has changed dramatically. In 1922, China was considered an unequal trade partner—a market which Western companies competed for under rules that were laid down by their own governments, not by the Chinese Government. Prior to the Communist occupation of the China mainland in 1949, approximately 250 companies were conducting business there under the China Trade Act. At the time the Act was enacted, this situation no longer existed, trade being restricted to Hong Kong and Formosa; nor was it likely to exist in the foreseeable future. At that time there were only three active CTA corporations, which reportedly accounted for a rather negligible amount of trade.

Thus, the original purpose of the China Trade Act, that of expanding trade with China, was no longer being served by the very favorable tax advantages it provided. Moreover, there were innumerable U.S. companies currently trading in Hong Kong and Formosa without the extensive tax benefits provided by the China Trade Act.

The tax advantages enjoyed by a CTA corporation, and particularly its shareholders, were almost without parallel. While there are cases where U.S. tax is not owing with respect to corporate income derived by a foreign subsidiary involved in an active trade or business abroad, dividend payments received from such corporations by U.S. shareholders are subject to U.S. taxation. There was no longer any justification for exempting CTA corporation dividends paid to its Hong Kong and Formosa resident shareholders who were U.S. citizens.

Explanation of provision

The Act provides for a phaseout over a 3-year period of the provisions permitting special tax treatment for CTA corporations and their shareholders. Thus, the special deduction allowable under section 941(a) and the dividend exclusion under section 943 will be reduced by one-third for taxable years beginning in 1976, by two-thirds for taxable years beginning in 1977, and repealed for taxable years beginning in 1978.[4]

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[3] For example, if in a given year, a CTA corporation, whose shareholders were U.S. citizens residing in Hong Kong or Formosa, had $500,000 of taxable income and paid a special dividend of at least $233,500 to its shareholders, neither the corporation nor its shareholders would incur any U.S. tax liability, whereas a domestic corporation and its shareholders in this situation (assuming marginal tax brackets of 50 percent for the shareholders) would incur respective U.S. tax liabilities of $233,500 and $116,750. The tax savings to the CTA corporation and its shareholders in the above example would be $350,250. If the balance of the earnings of the CTA corporation were paid out, the tax savings would be even greater.

[4] For example, if the taxable income before the special deduction of a CTA corporation was $100,000 and the special dividend was $41,500, the special deduction for the corporation and the amount of dividend excludible from income for taxable years beginning in 1976 would be $66,667 and $13,833, respectively. For taxable years beginning in 1977, the amounts would be $33,333 and $27,667. For taxable years beginning in 1978 and subsequent years, the CTA provisions are repealed and no special deduction nor dividend exclusion would be available.

Effective date

The provision phasing out China Trade Act corporations applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision is expected to increase receipts by less than $5 million per year.

13. Denial of Certain Tax Benefits for Cooperation With or Participation in an International Boycott (secs. 1061–1064, 1066 and 1067 of the Act and secs. 908, 952, 995 and 999 of the Code)

Prior law

U.S. taxpayers operating abroad receive a number of benefits or incentives which enable them to compete with foreign-owned businesses or to increase the export of U.S.-made goods. The three major tax provisions which are significant in connection with overseas operations are (1) the foreign tax credit for foreign taxes paid, (2) the deferral of earnings of foreign subsidiaries, and (3) the deferral of earnings of Domestic International Sales Corporations.

Prior law contained no tax provisions dealing with international boycotts and thus taxpayers were entitled to receive these tax benefits with respect to operations in connection with which they agreed to participate in an international boycott.

Reasons for change

Congress is concerned that U.S. businesses have been prevented from freely operating in international markets by the threat of economic sanctions by certain foreign countries or their nationals or companies. Unless the U.S. businesses agree to participate in or cooperate with certain foreign countries in an international boycott, they are denied the opportunity to conduct business with a country. Congress believes that it is particularly unfair to those taxpayers who refuse to participate in the boycott, when the taxpayer who does participate in the boycott is a recipient of tax benefits by reason of the participation. Congress believes that many taxpayers would not participate in an international boycott if the taxpayer and the foreign countries were made aware that tax benefits were not available to a taxpayer who participates in a boycott.

Congress believes that these three tax benefits referred to above in connection with overseas operations should not be made available with respect to operations in connection with which there has been an agreement to participate in or cooperate with an international boycott.

Explanation of provision

The Act denies to any person who agrees to participate in or cooperate with any international boycott the benefits of the foreign tax credit, deferral of earnings of foreign subsidiaries, and DISC to the extent these tax benefits are attributable to operations of that person (or its affiliates) in connection with which there was an agreement to participate in or cooperate with an international boycott.

The benefits of deferral and DISC are denied to the taxpayer by requiring a deemed distribution of earnings to the shareholders of the DISC or controlled foreign corporation. The benefits of the foreign tax credit are denied to the taxpayer by reducing the otherwise allowable foreign tax credit to which the taxpayer would be entitled under section 901, 902, and 960 of the Code, after applying the limitation, if applicable, of section 907. Where a foreign corporation has agreed to participate in or cooperate with the boycott, the otherwise allowable indirect foreign tax credits to which the United States shareholders would be entitled (under sec. 902 or 960) are reduced under the Act regardless of whether the foreign corporation is a controlled foreign corporation (i.e., more than 50 percent of its stock owned by U.S. shareholders). Taxes which are denied the foreign tax credit under this provision are not entitled to be carried back or forward as foreign tax credits but may be eligible to be deducted in computing taxable income. Of course, if so deducted, the rules of sections 861 and 862 will apply with respect to the deduction.

The loss of deferral benefits is accomplished under the Act by treating as subpart F income the earnings attributable to boycott participation. Thus, deferral benefits are only lost with respect to earnings of controlled foreign corporations. Each U.S. shareholder of the controlled foreign corporation (that is, each U.S. person owning, or treated under the applicable attribution rules as owning, at least 10 percent of its stock) is currently to include in income under the subpart F provisions its pro rata portion of the earnings of the controlled foreign corporation attributable to boycott participation, whether or not the shareholder and the controlled foreign corporation are members of the same controlled group.

The denial of DISC benefits is accomplished by treating as a deemed distribution by a DISC to its shareholders the earnings of the DISC attributable to the boycott participation. The deemed distribution is similar to the other deemed distributions from a DISC to its shareholders. Thus, the amount deemed distributed is, for purposes of computing the DISC earnings and profits, treated as being part of the previously taxed income account.

A person participates in or cooperates with an international boycott if the person agrees, as a condition of doing business directly or indirectly within a country or with the government, a company, or a national of a country (1) to refrain from doing business with or in a country which is the object of an international boycott or with the government, companies, or nationals of that country; (2) to refrain from doing business with any U.S. person engaged in trade within another country which is the object of an international boycott or with the government, companies, or nationals of that country; (3) to refrain from doing business with any company whose ownership or management is made up, all or in part, of individuals of a particular nationality, race, or religion, or to remove (or refrain from selecting) corporate directors who are individuals of a particular nationality, race, or religion; (4) to refrain from employing individuals of a particular nationality, race, or religion; or (5) to refrain from shipping or insuring products on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott. While it is anticipated that in most cases a third country will be the object of an international boycott, it is possible that the United States may be the object of an international boycott. The agreement may be with respect to any type of business (including manufacturing, banking, and service businesses).

The Act permits a person to agree to comply with certain laws without being treated as agreeing to participate in or cooperate with an international boycott. A person may agree to meet requirements imposed by a foreign country with respect to an international boycott if a U.S. law, executive order, or regulation sanctions that participation or cooperation. Secondly, the person may agree to comply with a prohibition on the importation of goods produced in whole or in part in any boycotted country or to comply with a prohibition imposed by a country on the exportation of products obtained in that country to any boycotted country. The person however, may not agree to refrain from importing or exporting to or from a particular country products which are, or which contain components which are, made by a company on a boycott list.

A person is not considered as having participated in or cooperated with an international boycott unless he has agreed to such participation or cooperation. The agreement need not be in writing; there may be an implied agreement. However, an agreement will not be inferred from the mere fact that any country is exercising its sovereign rights. Thus, a person is not considered to have agreed to participate in or cooperate with an international boycott merely by reason of the inability of the person to obtain an export or import license from a sovereign country for specific goods. Similarly, a person's inability, under the laws or administrative practices of a country, to bring certain personnel into that country, to bring certain ships into the waters of that country, to provide certain services in that country, or to import or export certain products to or from a country, is not to be considered to constitute an agreement to participate in or cooperate with an international boycott. Further, the signing (at the time of import) of a certification as to content, which is required to obtain an import license, does not by itself constitute an agreement by the person. However, this will not permit the making of an agreement not to import certain goods into the country. In addition, a course of conduct of complying with sovereign law may, along with other factors, be evidence of an agreement.

If a person or a member of the controlled group (within the meaning of section 993(a)(3)) which includes that person has participated in or cooperated with an international boycott in a country, that person or group is presumed to have participated in or cooperated with that boycott with respect to all operations in all countries which require of the person (or of other persons, whether or not related to that person) participation in or cooperation with that international boycott. However, the taxpayer may establish that he has, or related persons have, conducted clearly separate and identifiable operations in that country or another country with respect to which there is no cooperation with or participation in that boycott. Where the person involved is a foreign corporation, its United States shareholders (within the meaning of section 951(b) of the Code) may establish that it has conducted clearly separate and identifiable operations with respect to which there has been no participation in or cooperation with the boycott.

Where there are not continuous business activities within a country, separate and identifiable operations may include separate export or import transactions. Where there are continuous business activities within a country, each separate business activity (taking into account basic differences in the types of any products sold or services offered, clear separation of the management of the activities, and so forth) may represent a separate and identifiable operation. If the taxpayer is able to establish separate and identifiable operations, he may then establish that with respect to certain operations there was no participation in or cooperation with that international boycott. The burden of proof will be upon the taxpayer to establish that an operation is separate and identifiable and that there was no participation in or cooperation with an international boycott in connection with that operation.

In addition, the Act contains a special rule extending the presumption of participation to related persons in certain limited situations where the related persons are not members of the same controlled group (under sec. 993). The rule provides that if a person (e.g., an individual or a corporation) controls a corporation, (1) participation in or cooperation with an international boycott by the corporation is presumed to be participation in or cooperation with the boycott by that person (and thus by all members of the controlled group including that person), and (2) participation or cooperation by the person is presumed to be participation or cooperation by the controlled corporation (and thus by all members of the controlled group including that corporation). Control for this purpose has the same meaning as it does in Code section 304(c); that is, a person is considered to control a corporation if, after application of the appropriate attribution of stock ownership rules, the person owns at least 50 percent of stock of the corporation. Thus, the presumption applies in the case of noncorporate shareholders owning at least 50 percent of a corporation's stock, or corporate shareholders owning only 50 percent of a corporation's stock, even though in both cases the shareholders are not members of the same controlled group as the corporations in which they own the stock interest. As above, however, the taxpayer may rebut the presumption by establishing clearly separate and identifiable operations with respect to which there was no boycott participation.

In addition, the Act provides a proration formula for computing the amount of tax benefits which are related to an international boycott, and thus are denied to the taxpayer. This formula, it is anticipated, will be used by taxpayers who are unable to separate their tax benefits between boycott and nonboycott operations. Under this formula, the reduction of the tax benefits allowed to the taxpayer are determined by multiplying the otherwise allowable tax benefits by a fraction. Generally, the numerator of the fraction reflects the worldwide operations of the taxpayer (or, in the case of a controlled group within the meaning of sec. 993(a)(3) which includes that taxpayer, of the group) in countries associated in carrying out the international boycott (exclusive of those operations for which the presumption of participation or cooperation has been rebutted). The denominator reflects the worldwide foreign operations of the taxpayer (or the group). The factors to be taken into account in computing the fraction are to be determined in accordance with the regulations prescribed by the Secretary. It is anticipated that the regulations will reflect the nature of the boycott activity carried on by the taxpayer (or group) and will take into account such factors as purchases, sales, payroll or other items which may be relevant. Unless the taxpayer establishes to the contrary, all operations of the taxpayer (or group) in connection with countries which require participation in or cooperation with the boycott are to be reflected in the numerator of the fraction.

A U.S. taxpayer is to take into account the operations of all members of the same controlled group to which it belongs in computing its international boycott factor. However, if the taxpayer is a shareholder of a person who is not a member of a controlled group with the U.S. taxpayer, and that person has agreed to cooperate with or participate in an international boycott, the U.S. taxpayer is to compute separately the international boycott factor with respect to that person (and any corporation controlled by that person) for purposes of determining the DISC benefits, deferral of earnings of a foreign subsidiary or deemed paid foreign tax credit, the benefits of which are denied to that U.S. taxpayer.

The proration formula is not to apply if instead the taxpayer, with respect to the operations which are related to participation in or cooperation with an international boycott, clearly demonstrates the amount of the foreign taxes and earnings which are allocable to the boycott operations. Those taxpayers who are not able clearly to account separately for the foreign taxes and earnings which are allocable to boycott operations must apply the proration formula in computing the amount of tax benefits which are denied to them. Of course, all operations of the person in countries which require participation in or cooperation with that boycott are presumed to be boycott operations unless the taxpayer establishes to the contrary.

It is expected that the provisions of the Act will be administered in the normal course of a tax audit. However, if a person, or a member of a controlled group (within the meaning of section 993(a)(3)) which includes that person, has operations in or related to a country (or with the government, a company, or a national of a country) which is on a list (maintained by the Secretary of the Treasury) of countries requiring participation in or cooperation with an international boycott, or in any other country which the person (or if the person is a foreign corporation, any United States shareholder of the corporation) knows or has reason to know requires boycott participation or cooperation, that person or shareholder must report those operations to the Secretary of the Treasury. In the case of these operations of a foreign subsidiary, however, the report is to be made by its United States shareholders.

The taxpayer is to include in the report the identity of any country in connection with which the taxpayer has participated in or cooperated with (or has been requested to participate in) an international boycott as a condition of doing business in that country (or with such government, company or national). The report should also indicate the nature of any operations in connection with such countries. A taxpayer will also be expected to disclose in the report any country where the taxpayer has been requested to participate in such a manner which could be interpreted as an official request of that country. This is not to say that the request must be made directly by a government official or representative.

The Secretary of the Treasury is to publish the list, which is to be updated periodically, of those countries which may require participation in or cooperation with an international boycott. The initial list must be published within 30 days after date of enactment. However, the absence of a country from the list does not mean that the country is not a country which requires participation in or cooperation with an international boycott.

The willful failure to make a report will subject the taxpayer to a fine of not more than $25,000 or imprisonment for not more than one year, or both. A failure to make a report will not be a willful failure if the taxpayer had no knowledge of a boycott operation unless the taxpayer's failure to have knowledge is so negligent as to constitute a reckless disregard of the requirements of the law.

The initial determination of participation in or cooperation with any international boycott is to be made by the taxpayer, who will be expected on his return to reduce the amount of the foreign tax credit, deferral benefits, or DISC benefits to the extent necessary to reflect the participation in or cooperation with an international boycott. The taxpayer is to show how any reduction is made. However, it is expected that the returns and the determinations by the taxpayer will be audited and the accuracy of the taxpayer's determinations will be verified in the usual course of such an audit. While this verification will be done in the usual course of a tax audit, it is anticipated that the IRS will develop a group of experts who are knowledgeable in audit aspects of determining whether a taxpayer is involved in an international boycott.

The Act also establishes a determination procedure so that taxpayers conducting business with foreign countries will be able to obtain a determination from the Secretary of the Treasury as to whether their operations constitute an international boycott agreement. While the determination procedure may rely upon the audit expertise of the IRS, it is anticipated that this procedure will be delegated to Treasury officials. The determination request may be filed by the taxpayer before he has computed and filed his tax return, or at any time during the course of an audit of a tax return in which the question is raised as to whether the taxpayer has agreed to participate in or cooperate with an international boycott. To obtain a determination from the Secretary, the taxpayer will be required to make available all factual materials which may be relevant to the Secretary's determination. If the request for a determination is made before the particular operation is commenced or before the close of the taxable year, the Secretary may defer making the determination until the close of the taxable year.

If the Secretary does determine that a person has agreed to participate in or cooperate with an international boycott, there will be a presumption that the participation or cooperation of the person relates to all of the operations of the taxpayer in all of the boycott countries involved. However, the taxpayer will be entitled to rebut this presumption by demonstrating that certain operations are clearly separate and identifiable and are not connected with an international boycott agreement. An adverse determination by the Secretary will be reflected by the taxpayer either directly in his return or by normal deficiency procedures of the Internal Revenue Service. Thus, a determination by the Secretary that a person has agreed to participate in or cooperate with an international boycott will be reviewable by the courts in the same manner as the usual tax controversy.

In order to assess the effectiveness of this legislation in discouraging participation in or cooperation with international boycotts, the Act requires the Secretary to report annually to the taxwriting committees the number of boycott reports filed with the IRS and the percentage which indicated that there had been participation in an international boycott. Further, the report to the committees should contain a detailed description of the results of the audits of these taxpayers in connection with boycott operations, the changes made by the IRS on unreported boycott activities, and such other information which would be useful or helpful in evaluating the administration of these provisions. The report should also indicate to the extent possible the tax benefits which are claimed for operations in each boycott country; the benefits claimed by taxpayers in those countries and the benefits denied by application of these provisions; and the extent that benefits denied were attributable to boycott agreements determined by reason of an Internal Revenue audit. The report must be in such a form that it cannot, directly or indirectly, be associated with or otherwise identify a particular taxpayer.

Effective date

The international boycott provisions apply to any participation in or cooperation with an international boycott made more than 30 days after the date of enactment (October 4, 1976). However, in the case of operations which are carried out in accordance with the terms of a binding contract entered into before September 2, 1976, the international boycott provisions apply to participation or cooperation after December 31, 1977.

Revenue effect

It is estimated that the international boycott provisions will increase budget receipts by $32 million in fiscal year 1978, and by $70 million in fiscal year 1981.

14. Denial of Certain Tax Benefits Attributable to Bribe-Produced Income (secs. 1065 and 1066 of the Act and secs. 952, 964(a), and 995(b)(1) of the Code)

Prior law

Under prior law, illegal payments to government officials were not deductible, but the denial of the deduction for bribes had little impact on bribes paid by foreign subsidiaries or DISCs.

Reasons for change

Prior law in many cases provided more favorable tax treatment for illegal payments made by a foreign subsidiary of a U.S. corporation than by its parent. Further, the Congress is concerned over the recent revelations that disclosed the practice of using foreign bribes as a means of doing business overseas. The Congress believes that illegal payments made out of funds entitled to tax deferral should cause the termination of the tax deferral.

Explanation of provisions

The Act subjects to current taxation as a deemed dividend an amount equal to the amount of any illegal bribes, kickbacks, or other payments (within the meaning of section 162(c)) paid by or on behalf of a DISC or a controlled foreign corporation (a foreign corporation more than 50 percent of the stock of which is owned by United States shareholders) directly or indirectly to an official or employee of any government (or of any agency or instrumentality of any government). Illegal payments include payments which are unlawful under the laws of the United States or, if made to an official or employee of a foreign government, payments which would be unlawful under the laws of the United States if such laws were applicable.

In the case of a controlled foreign corporation, the deemed dividend is accomplished by treating an amount equal to the bribe as subpart F income includible in the income of the subsidiary's United States shareholders in the same manner as other subpart F income. In the case of a DISC, the deemed dividend is made under the same rules which are applicable to other deemed distributions required during qualified years (e.g., deemed distributions of interest on producer's loans).

In addition, the earnings and profits of any foreign subsidiary which has made an illegal payment are not to be reduced by the amount paid.

Effective date

The provisions dealing with the making of illegal payments by foreign corporations apply to payments made after November 3, 1976.

Revenue effect

It is estimated that these provisions will increase budget receipts by less than $5 million on an annual basis.

J. DOMESTIC INTERNATIONAL SALES CORPORATIONS

(Sec. 1101 of the Act and Secs. 991–997 of the Code)

Prior law

The tax law provides for a system of tax deferral for corporations known as Domestic International Sales Corporations, or "DISCs", and their shareholders. Under this tax system, the profits of a DISC are not taxed to the DISC but are taxed to the shareholders of the DISC when distributed to them. However, each year a DISC is deemed to have distributed income representing 50 percent of its profits, thereby subjecting that income to current taxation in the shareholders' hands. In this way, under the prior rules, the tax deferral which was available under the DISC provisions was limited to 50 percent of the export income of the DISC.

To qualify as a DISC, at least 95 percent of the corporation's assets must be export-related and at least 95 percent of a corporation's gross income must arise from export sale or lease transactions and other export-related activities (i.e., qualified export receipts). Qualified export receipts include receipts from the sale of export property, which generally means property such as inventory manufactured or produced in the United States and held for sale for direct use, consumption or disposition outside the United States (or to an unrelated DISC for such a purpose). The President has the authority to exclude from export property any property which he determines (by Executive order) to be in short supply. However, energy resources, such as oil and gas and depletable minerals, are automatically denied DISC benefits under the Tax Reduction Act of 1975. That Act also eliminated DISC benefits for products the export of which is prohibited or curtailed under the Export Administration Act of 1969 by reason of scarcity.

If a DISC fails to meet the qualifications for any reason (including legislation excluding the corporation's products from export property), the DISC provisions provide for an automatic recapture of the DISC benefits received in previous years. Under prior law, this recapture was spread out over the number of years for which the corporation was qualified as a DISC but could not exceed 10 years. In addition, the DISC provisions provide for recapture of the DISC benefits if the stock of the DISC is sold or exchanged.

Reasons for change

Congress has examined the DISC provisions at great length and has concluded that the legislation has had a beneficial impact on U.S. exports. Since 1971, when DISC was enacted, exports have increased from $43 billion to $107 billion for 1975. It is clear that much of this increase has resulted from the devaluation of the dollar which took place in that period. Nonetheless, Congress has concluded that a significant portion of the increase in exports which has taken place resulted from the DISC legislation. This increase in exports, Congress concluded, provides jobs for U.S. workers and helps the U.S. balance of payments.

However, Congress also recognized that questions have been raised as to the revenue cost of the DISC program. In 1975, the program is estimated to have cost nearly $1.3 billion and it is estimated that in 1976 the amount would have been $1.4 billion. Furthermore, Congress believed that the DISC legislation was made less efficient because the benefits applied to all exports of a company, regardless of whether or not a company's products would be sold in similar amounts without export incentive and regardless of whether or not the company was increasing or decreasing its exports.

Given these considerations, Congress concluded that the DISC program could become more efficient and less costly while still providing the same incentive for increased exports and jobs by granting DISC benefits only to the extent that a company increases its exports over a base period amount and by reducing DISC benefits for certain products and commodities.

Explanation of provisions

Incremental computation of DISC benefits.—Under the Act, the tax deferral benefits provided to a DISC and its shareholders are to be computed on an incremental basis. However, the basic structure of the DISC provisions of prior law are continued. DISCs continue not to be taxable entities themselves, but certain amounts of the taxable income of the DISCs are deemed distributed to the shareholders of the DISCs and taxed to them. Furthermore, the requirements for qualifying as a DISC are to remain the same, as are the intercompany pricing rules and most of the technical provisions of the DISC provisions.

Deemed distribution.—The Act provides for the incremental computation of DISC benefits by adding a new category of deemed distribution from a DISC to its shareholders. The amount of this new deemed distribution is the adjusted taxable income for the current taxable year which is attributable to adjusted base period export gross receipts (i.e., the nonincremental portion of the current year's export receipts).

Adjusted taxable income is the taxable income of the DISC in the current year reduced by producer's loan interest and gain on the sale of certain property of the DISC. These amounts are deemed distributions from a DISC to its shareholders under prior law. The amount of the new deemed distribution is that portion of the current year's adjusted taxable income which is attributable to the current year's export gross receipts not in excess of the adjusted base period export gross receipts. For example, if adjusted base period export gross receipts were $100 and the current year's export gross receipts were $300, one-third of the adjusted taxable income of the DISC in the current year would be treated as attributable to adjusted base period export gross receipts and thus would be a deemed distribution for the current year.

The deemed distribution is computed by taking the ratio of "adjusted base period export gross receipts" of the DISC to the export gross receipts for the current year and multiplying it by the adjusted taxable income of the DISC for the current year. Adjusted base period export gross receipts are defined as 67 percent of the average of the DISC's export gross receipts during a moving 4-year base period. Thus, this nonincremental dividend is computed as follows:

$$\text{DISC income for current year} \times \frac{\text{67 percent of the average base period export gross receipts}}{\text{Export gross receipts for current year}}$$

The nonincremental dividend is to be deemed distributed to the shareholder prior to the computation of the deemed distribution (provided under prior law) equal to one-half of the taxable income of the DISC. That is, adjusted taxable income attributable to adjusted base period export gross receipts is to be deemed distributed first, and then one-half of remaining taxable income of the DISC is to be deemed distributed. For example, if a DISC had taxable income of \$100 and taxable income attributable to the adjusted base period export gross receipts of \$30, the deemed distributions for the year would be \$65 (\$30+½(\$100−\$30)). Thus, a deferral of tax would be permitted on \$35.

Export gross receipts.—The term "export gross receipts" includes those receipts which are received in the ordinary course of the export trade or business of the DISC in which the DISC derives its income (see sec. 993(a)). For this reason, the term includes income from the sale, exchange, or rental (and related subsidiary services) of export property (as defined in sec. 993(c)) for consumption outside of the United States; engineering and architectural services for projects outside the United States; and the performance of managerial services for a DISC which relate to the sale, exchange, rental or other disposition of export property. However, the term does not include gross receipts from the sale, exchange or other disposition of qualified export assets (under sec. 993(b)) other than export property (i.e., assets such as warehouses and packaging machines which generally are used in the export business but which are not sold in the ordinary course of business); dividends or deemed distributions (under subpart F) from a related foreign export corporation (as defined in sec. 993(e)); and interest on any obligation (such as Export-Import Bank obligations) which is a qualified export asset.

Base period years.—Under the Act, the base period for taxable years beginning in 1976, 1977, 1978, and 1979 is composed of the DISC's taxable years beginning in 1972, 1973, 1974, and 1975. In taxable years beginning in 1980 and later years, the base period becomes a 4-year moving base period. The base period is to move forward 1 year for each year beyond 1979, so that the base period years for any year are the taxable years beginning in the 4th, 5th, 6th, and 7th calendar years preceding such calendar year. For example, for 1980, the base period years are 1973, 1974, 1975, and 1976, and for 1981, the base period years are 1974, 1975, 1976, and 1977.

The average export gross receipts for the base period is the sum of the export gross receipts for the 4 base period years divided by 4. If the taxpayer did not have a DISC in any year which would be included in the base period for the current year, the taxpayer is to calculate base period export gross receipts by attributing a zero amount of export gross receipts to that base period year. For example, in the case of a DISC which was not in existence in 1973 and 1974, but had $25 of export gross receipts in 1975, and $35 in 1976, the base period export gross receipts of the DISC for taxable year 1980 would be ($0+$0+$25+$35) divided by 4 or $15. Sixty-seven percent of this average, or roughly $10, would be the adjusted base period export gross receipts of the DISC.

Because base period years in which a DISC was not in existence are included as zero base period years under these provisions, DISCs beginning operation in 1976 have no base period export gross receipts for 4 full years (until 1980), when the base period begins to include a year in which the DISC had export gross receipts. In 1980 its base period export gross receipts would be its 1976 export gross receipts divided by 4. The DISC would thus first have a full 4-year base period in 1983.[1]

Short taxable years.—In the case of a taxpayer having a short taxable year in the base period, the Secretary is to prescribe regulations including the annualization, if necessary, of export gross receipts in the short base period taxable year or years in determining base period export gross receipts. Similar regulations are to be prescribed if the current year is a short year in order to compute the deemed distribution. It is intended that under these regulations short taxable years in the base period will generally be annualized for purposes of determining base period export gross receipts so that the amount of the increase in current year export gross receipts is based on an equivalent full year amount of export gross receipts in each base period year. Similarly, in cases where the current year is a short taxable year, it is intended that export gross receipts in the current year will generally be expanded proportionately by the ratio of the length of the short taxable year to a full taxable year. Of course, this adjustment is only to affect the computation of export gross receipts to be used in determining the amount of the current year's taxable income which is attributable to base period export gross receipts. The adjustment is not to affect the amount of taxable income of the DISC for the current taxable year or the amount of accumulated DISC benefits from any base period year.

Adjustments to base period.—The Act includes three special rules to deal with situations where a corporation has an interest in more than one DISC, or where a DISC and the underlying trade or business

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[1] The incremental computation of DISC benefits can be illustrated by the following example:

In 1980 a DISC makes exports of $13,400, and that the taxable income allocable to the DISC is $500. Assume further that the DISC was established in 1974 and that the exports through the DISC during the applicable base period are:

1973	0
1974	$2,000
1975	6,000
1976	8,000

Assuming all the exports are of nonmilitary goods, the DISC benefits would be computed as follows:

(*a*) DISC's income on exports	$500
(*b*) Average base period export gross receipts ($16,000/4)	4,000
(*c*) Adjusted base period export gross receipts (67 percent of (b))	2,680
(*d*) Export gross receipts for current year	13,400
(*e*) Nonincremental portion of the DISC's income ((a) times (c)/(d))	100
(*f*) DISC income remaining after nonincremental dividend ((a)−(e))	400
(*g*) Regular deemed distribution of 50 percent of DISC income	200
(*h*) DISC income eligible for deferral	200

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giving rise to the DISC income have been separated. The purposes of these rules are, first, to insure that in every year the base period export gross receipts which are attributable to a DISC for purposes of deemed distributions in the current year are appropriately matched with the current period export receipts of the DISC and, second, to prevent taxpayers from creating multiple DISCs, or trading DISCs, to reduce deemed distributions attributable to base period export gross receipts.

Controlled group. The Act provides that if one or more members of a controlled group of corporations (as defined in sec. 993(a)(3) to include all corporations with 50 percent or more common ownership) qualify as a DISC in the current or base period years, the amount deemed distributed as taxable income attributable to adjusted base period export gross receipts to the common shareholder of the DISCs (and the adjusted taxable income for purposes of the small DISC rule) is to be determined by aggregating taxable income, current year export gross receipts, and base period export gross receipts of the commonly owned DISCs. This aggregation is to be accomplished under regulations prescribed by the Secretary and is to be reflected on a pro rata basis (i.e., according to taxable income) in each DISC for purposes of determining the deemed distribution from each DISC. The Secretary's regulations thus are not intended to require aggregation of commonly owned DISCs for all purposes (including for purposes of meeting the qualifications of a DISC). Rather, this aggregation is to be required only to the extent necessary so that a taxpayer which exports through more than one related DISC (in the current year or the base period), cannot gain any advantage by increasing its exports in one DISC or the other, since the base period of all DISCs are taken into account in determining the amount of the deemed distribution of taxable income attributable to base period export gross receipts. In determining base period export receipts for this purpose, commonly owned DISCs are to use the same 4 base years during the base period. It is intended that in cases where two DISCs are members of a controlled group, but where an unrelated person owns some stock in one of the DISCs, the aggregation rule does not apply in computing any deemed distribution to that shareholder.

Separation of DISC and its trade or business.—A second special rule is provided for situations where the ownership of a DISC and the underlying trade or business which gives rise to the export gross receipts of the DISC are separated. This could arise through the sale of the underlying trade or business or through a tax-free reorganization in which the DISC and the underlying trade or business are separated. The special rule requires that a person owning the underlying trade or business during the taxable years after the separation of the trade or business from the DISC be treated as having, in any DISC in which the owner of the trade or business has an interest, an amount of additional export gross receipts for base period years equal to export gross receipts in base period years of the DISC attributable to that trade or business.

The effect of this provision is to provide a double attribution of base period export gross receipts in cases where a DISC is separated from the underlying trade or business through a tax-free reorganization or through a sale of the underlying trade or business. In these cases the base period export gross receipts of the DISC also remain with the DISC and are to be taken into account by the shareholders of the DISC (whether or not the DISC has acquired new shareholders in a tax-free reorganization) in computing adjusted base period export gross receipts of the DISC for years prior to the reorganization or sale.[2]

Since, in the case of a sale or disqualification of a DISC, the DISC benefits for prior years are recaptured, export gross receipts for base period years prior to any sale (or disqualification) are to be reduced on a pro rata basis to the extent of the recapture. For example, if a DISC which was disqualified was entitled to defer $100 of accumulated DISC income, $40 of which was recaptured, the export gross receipts for the base period years are to be reduced by 40 percent.

A separation of the DISC and the underlying trade or business does not occur if the DISC and the trade or business which gave rise to the base period export gross receipts of the DISC are owned throughout the current taxable year by members of the same controlled groups, but only to the extent that the ownership of the DISC and the trade or business is proportionate during all of the current taxable year (i.e., the taxpayer owns the same proportionate amount of stock in the DISC as it owns in the trade or business during the current year). As a result, in cases where a DISC is transferred at the same time that the underlying trade or business is transferred (either by sale or tax-free reorganization), the double attribution of the base period export gross receipts of the DISC does not apply. The intent of these provisions is to prevent taxpayers from separating a DISC from the underlying trade or business giving rise to the export gross receipts of the DISC in order to reduce base period export gross receipts.

In order to permit the transfer of a DISC and the transfer of the underlying trade or business as part of the same exchange, the Act provides special rules modifying the corporate spinoff provisions. The Act provides that if (i) a corporation owns the stock of a subsidiary and of a DISC, (ii) the subsidiary has been engaged in the active conduct of a trade or business for the requisite 5-year period, and (iii) during the taxable year of the subsidiary in which its stock is transferred and during its preceding taxable year, the trade or business of the subsidiary gave rise to qualified export receipts, the Secretary is to prescribe regulations under which the transfer of assets, stock, or both will be treated as a reorganization within the meaning of section 368, a transaction to which section 355 applies, or an exchange to which section 351 applies. This special treatment will apply only to the extent that the transfer is for the purpose of preventing the separation of the ownership of the stock in the DISC from the ownership of the trade or business which produced the base period export gross receipts of the DISC.

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[2] For example, if a DISC alone is transferred in a section 355 spin-off transaction, the shareholders of the DISC after the transfer will in computing any deemed distributions, take into account the adjusted base period export gross receipts for all base years of the DISC, including years prior to the section 355 transaction. In addition, the owners of the trade or business from which the DISC is spun off will also be treated as having base period export gross receipts equal to the amount of the base period export gross receipts of the DISC which was spun off. These amounts are to be added to any base period export gross receipts which may exist in any DISC in which the owners of the trade or business have an interest or subsequently obtain an interest.

Shareholders of two or more unrelated DISCs.—A final special rule is provided to apply to situations where a person owns a partial interest in a DISC (i.e., 5 percent or more of the stock of a DISC). Under this rule, if a person has had an interest in more than one DISC (either simultaneous ownership or ownership of one DISC during the base period and ownership of the second DISC during the current year), then, to the extent provided in regulations prescribed by the Secretary to prevent circumvention of the rules for deemed distributions of taxable income attributable to adjusted base period export gross receipts, amounts equal to that shareholder's pro rata portion of the base period export gross receipts of DISCs owned during the base period are to be included in base period export gross receipts of DISCs currently owned by the shareholder. This provision is intended to give the Secretary general authority to prevent situations where, by having an interest in more than one DISC, a taxpayer could artificially reduce the base period export gross receipts that would otherwise be attributable to a currently active DISC in order to obtain a smaller deemed distribution in the current year.

Where the provisions of the first two special rules are applied, it is contemplated that generally the rules regarding deemed distributions will not have been circumvented, and thus no further adjustment of base period export gross receipts is to be required. Further, it is intended that this provision will generally not be applied in cases where a taxpayer has sold all the shares he held in any DISC, since the amount of benefits received from that DISC will have been recaptured. However, the Secretary is to have authority to attribute base period gross receipts to more than one DISC in cases of separations and acquisitions of DISCs from underlying trades or businesses if such double attribution is consistent with the purposes of the special rules of the Act and is appropriate to eliminate any incentive to separate DISC assets from their underlying trades or businesses.

Small DISCs exception.—The Act exempts small DISCs from the new incremental rules. Under the Act, DISCs with adjusted taxable income in the current taxable year of $100,000 or less are not subject to the new incremental rules. Instead, these DISCs will continue to receive the full DISC benefits provided under prior law. The exception is phased-out on a 2-for-1 basis so that DISCs with taxable income of $150,000 or more receive no benefit. In computing adjusted taxable income for purposes of the small DISC exception to the incremental rules, if more than one member of a controlled group qualifies as a DISC, the small DISC exemption is computed by aggregating the adjusted taxable income of each DISC who is a member of that group.

DISCs with taxable income of over $100,000 for a taxable year are to be treated as having made deemed distributions equal to the amount of their adjusted base period gross export receipts, but this amount is first to be reduced by twice the excess (if any) of the $150,000 over the DISC's adjusted taxable income. The effect of this provision is to phase out the special treatment for small DISCs on a 2-for-1 basis, so that DISCs with adjusted taxable income of $150,000 or more receive no benefit from the rule and DISCs with adjusted taxable income between $100,000 and $150,000 will lose $2 out of the $100,000 exemption for each $1 of adjusted taxable income beyond $100,000.[3]

Reduction of DISC benefits for military goods.—The Act reduces the DISC deferral on sales of military goods to half the amount which would otherwise be allowed. The reduction in DISC benefits on military sales is accomplished by requiring a deemed distribution of one half of the DISC's taxable income from military sales. The DISC's taxable income from military sales is its gross income from the sale of military property (gross receipts less cost of goods sold) reduced by the deductions properly allocable to that income. The determination of this amount may require separate accounting for military and nonmilitary sales. Military goods are defined as arms, ammunition, or implements of war designated in the munitions list published pursuant to the Military Security Act of 1954 (22 U.S.C. 1934). The list published pursuant to that statute appears at 22 Code of Federal Regulations, sec. 121.

The deemed distribution of the DISC income from military sales is made prior to the nonincremental and the regular 50 percent deemed distributions. In computing the nonincremental dividend, only half of the military sales are included in the ratio of the average gross receipts for the base period to the gross receipts for the current year.[4]

Exclusion from base period.—For purposes of establishing base period export gross receipts of a DISC some of the products of which have been made ineligible for DISC benefits under the Tax Reduction Act of 1975, an adjustment is to be made to reduce base period export gross receipts of that DISC to reflect the elimination of DISC benefits for those products or commodities. This adjustment is to be made by eliminating from each base period year the amount of actual exports of those commodities or products for which DISC benefits are eliminated for the current year. Thus, the amount of reduction in base period export gross receipts is to be computed by tracing and eliminating actual DISC sales in base period years.

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[3] For example, a DISC with adjusted taxable income of $130,000 which had adjusted base period export receipts of $200,000 might, without the small DISC provision, have a deemed distribution of $75,000 and thus would be eligible for DISC benefits only on the remaining $55,000. However, under the 2-for-1 phaseout this DISC would be eligible for DISC benefits on an additional $40,000 of its DISC income beyond the $55,000 amount (2 times ($150,000—$130,000)). The DISC would thus be treated as having made a deemed distribution of taxable income attributable to base period export gross receipts of $35,000 out of its adjusted taxable income in the current year of $130,000.

[4] The following example illustrates the computation of DISC benefits under the new rules. In 1980 a DISC exports $10,000 of military goods and $1,700 of other goods, and its taxable income for the year is $700, of which $600 is attributable to the military sales. Assume further that $12,000 of the $16,000 exports during the 1973–1976 base period were exports of military goods. In this factual situation, the DISC benefits would be computed as follows:

Military sales deemed distribution:	
(*a*) DISC's income on exports	$700
(*b*) DISC's income attributable to military sales	600
(*c*) Deemed distribution of ½ of income attributable to military sales	300
(*d*) DISC income remaining after military sales deemed distribution	400
Incremental distribution:	
(*e*) Average base period export gross receipts (($4,000 + ½ of $12,000)/4)	2,500
(*f*) Adjusted base period export gross receipts (67 percent of (e))	1,675
(*g*) Adjusted export gross receipts for current year ($1,700 + ½ of $10,000)	6,700
(*h*) Nonincremental portion of the DISC income ((d) times (f)/(g))	100
(*i*) DISC income remaining after military sales and nonincremental distributions	300
(*j*) Regular deemed distribution of 50 percent of DISC income (½ of (i))	150
(*k*) DISC income eligible for deferral	150

Special rules.—The Act also includes two provisions relating to the disqualification and recapture of accumulated DISC income of DISCs which exported goods for which DISC benefits have been eliminated. First, under the Act, if these DISCs continue to loan their accumulated DISC earnings to the parent company, these loans will continue to qualify as producers loans if they would otherwise qualify under the rules that were applicable before DISC benefits were eliminated for the goods which the DISC exported and which the parent continues to export. For example, in the case of a DISC selling coal, after the elimination of DISC benefits for those goods the DISC can continue to have qualified producers' loans to its parent to the extent that the parent exports goods which would (but for the elimination of DISC benefits for coal under the Tax Reduction Act of 1975) qualify for DISC benefits if sold through the DISC.

In addition, the Act provides that recapture of accumulated DISC earnings (because the DISC has become disqualified) is to be spread out over a period equal to two years for each year that the DISC was in existence (up to a maximum of 10 years), instead of the 1 year (up to a maximum of 10 years) provided under prior law.

The Act also includes two provisions to resolve technical problems in prior law. The first relates to recapture of accumulated DISC income upon disposition of stock of a DISC. Under prior law if stock in a DISC was distributed, sold, or exchanged in certain tax-free transactions (sec. 311, 336, or 337) there was no recapture because neither of the conditions for recapture were satisfied: no gain would be recognized and the corporate existence of the DISC would not be terminated. The Act specifically requires recapture under these circumstances. Conforming amendments with respect to the partnership provision have also been made (sec. 751(c)).

The second provision relates to the determination of the source of distributions to meet qualification requirements. Under prior law the combination of the general deemed distribution rule (which requires that shareholders be considered to have received 50 percent of the DISC's taxable income) and the rule prescribing the source of any distribution made to meet the 95 percent export receipts requirement could result in partial double counting of the DISCs taxable income insofar as terminating deferral of taxation to its shareholders was concerned.[5] The Act meets this problem of double counting by altering the source rules for distributions to meet qualification requirements.

Under the Act one-half of a distribution to meet qualification requirements (which is made to satisfy the requirement of sec. 992(a)(1)(A) relating to the 95 percent qualified export receipts requirement) is considered distributed according to the source rules of section

[5] For example, assume a DISC has $100 of taxable income $80 of which is attributable to qualified export receipts and $20 of which is not attributable to qualified export receipts. If the corporation qualifies as a DISC by reason of making a distribution to meet qualification requirements, $50 of the DISC's taxable income is taxed to the shareholders. The rules relating to distributions to meet qualification requirements make it necessary for the corporation to distribute $20 (the nonqualified export receipts). Since under prior law distributions to meet qualification requirements were deemed to come first from accumulated DISC income (and next from other earnings and profits), the $20 is taxed in full also. This results in the taxable income attributable to the nonqualified receipts being distributed in effect, one and one-half times—one-half as part of the 50 percent deemed distribution and in full as a distribution to meet qualification requirements.

996(a)(2) (i.e., first out of untaxed earnings) and the remaining one-half is considered subject to the source rules of section 996(a)(1) (first out of previously taxed earnings).[6]

Finally, the Act clarifies the category of products for which DISC benefits were eliminated under the Tax Reduction Act of 1975. In that Act it was intended that DISC benefits be repealed for articles the supply of which is exhaustible or nonrenewable (such as products derived from oil or gas or hard minerals). The statute as drafted refers to products "of a character with respect to which a deduction for depletion is allowable . . . under section 611". This reference to section 611 had the unintended result of including some articles the supply of which is inexhaustible or can be renewed (for example, timber). Because of this possible interpretation, the Act modifies the provision by limiting its application to products for which depletion is allowable under sections 613 or 613A.

Under this provision, if a product is eligible for percentage depletion (e.g., oil or gas), the exports of that product are not entitled to DISC benefits regardless of whether that DISC or its shareholder is eligible for percentage depletion.

Effective date

In general, the DISC provisions, including the provision establishing an incremental base for DISCs, apply to taxable years of DISCs beginning after December 31, 1975. The new incremental rules apply to income earned by the DISC in years beginning after 1975 even if the income is derived from a binding contract entered into in prior years.

The reduction in DISC benefits for military sales also applies to taxable income from military sales earned in taxable years beginning after December 31, 1975.

In addition, the Act amends the effective date provisions of the Tax Reduction Act of 1975 to provide a fixed contract exception for those products for which DISC benefits were eliminated under the Tax Reduction Act of 1975 (generally hard minerals and oil and gas), and allows this exception for sales, exchanges and other dispositions made after March 17, 1975, but before March 18, 1980. A fixed contract is defined as any contract which was, on March 17, 1975, and is at all times thereafter, binding on the DISC, or on a taxpayer which is a member of the same controlled group (within the meaning of sec. 993(a)(3)) as the DISC.

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[6] The effect of this provision can be seen by referring to the example used previously in describing the problem with prior law. If a corporation had $100 taxable income, $80 of which was attributable to qualified export receipts and $20 of which was attributable to receipts which did not qualify as qualified export receipts, it could still obtain qualification as a DISC if it made a distribution to meet qualification requirements (pursuant to sec. 992(c)) of $20. Under prior law, the full $20 was (according to the applicable source rules) considered to be first from accumulated DISC and hence taxable in full to the distributee shareholders. Under the Act, one-half of the $20 distribution is considered (according to to the source rules of sec. 996(a)(1)) to be first from previously taxed income with the remaining one-half first from accumulated DISC income (pursuant to sec. 996(a)(2). In this manner, the full amount of taxation to the shareholders (as a result of the deemed distribution of $50 pursuant to sec. 995(b)(1)(F) and the $20 distribution to meet qualification requirements) is $60 ($20 of nonqualified income plus $40, one-half of the qualified income) rather than $70 as under prior law.

The contract need not be formalized in writing in order to be binding, if the taxpayer can establish through substantial documentary evidence (such as Board of Directors' resolutions, letters of intent, etc.) that the contract was in fact binding and contained fixed price and fixed quantity provisions on and after March 17, 1975. However, the contract must not have been binding at any time prior to the date on which the DISC became qualified as a DISC or prior to the time the taxpayer and the DISC became members of the same controlled group.

In addition, only contracts under which the price and quantity terms relating to the products or commodities to be sold, exchanged, or otherwise disposed of cannot be increased with any discretion are to be considered fixed contracts. For example, if a contract permits a price increase only upon the occurrence of specified conditions not within the discretion of the seller (such as increased labor or raw material costs), which conditions do not include increases for income taxes, the contract is to be considered a fixed price contract. However, if the seller can vary the price of the product for unspecified cost increases (which could include tax cost increases), the contract is not to be considered a fixed price contract. Furthermore, if the quantity of products or commodities to be sold can be increased or decreased under the contract by the seller without penalty, the contract is not to be considered a fixed contract with respect to the amount over which the seller has discretion. For example, if a contract calls for a minimum delivery of x amount of a product but allows the seller to refuse to deliver goods beyond that minimum amount (or allows a renegotiation of the sales price of goods beyond that amount), then with respect to the amount above the minimum the contract is not a fixed quantity contract.

In cases where the binding contract rule allows for a continuation of DISC benefits for any DISC, the decrease in base period export gross receipts which is provided under the Act attributable to products for which DISC is eliminated is to be modified by adding back into the base period an amount of export sales equal to the amount of export sales in the base period for which DISC benefits have since been eliminated (without regard to the binding contract rule) multiplied by a fraction, the numerator of which is the amount of export sales for which DISC benefits are allowed (because of the binding contract rules) and the denominator of which is the amount of export sales for which DISC benefits would be eliminated in the current year (assuming that the binding contract rule were not in effect.) This rule, in effect, requires that a portion of the base period export gross receipts reduction due to the general elimination of DISC benefits for certain types of products is to be included in base period export gross receipts to the extent that the binding contract rule allows a continuation of any DISC benefits for any products in the current year.

Revenue effect

This provision will increase budget receipts by $468 million in fiscal year 1977, $553 million in fiscal year 1978, and $728 million in fiscal year 1981.

K. ADMINISTRATIVE PROVISIONS

1. Public Inspection of Written Determinations by Internal Revenue Service (sec. 1201 of the Act and sec. 6110 of the Code)

Prior law

As a well-established part of the tax system, the National Office of the Internal Revenue Service provides written advice to taxpayers on the tax treatment of their specific transactions.[1]

Advice with respect to a proposed transaction may be issued upon a written request from the taxpayer, giving factual details about the transaction and after the taxpayer answers the questions the IRS may have about the transaction. (Information provided by the taxpayer to the IRS often contains confidential financial (or personal) information about the taxpayer. Some of this information is repeated in the letter of advice that is issued by the IRS.) The letter of advice generally is called a "ruling" and is in the form of a letter to the taxpayer.[2]

The letter ruling to the taxpayer has been treated as "private" in the sense that it is issued in response to the request of the taxpayer and is officially kept confidential. Even if another taxpayer obtained a copy of a private ruling, he could not use it as a precedent in his own case. Private rulings applied only to the taxpayer who is the subject of the ruling.

In addition, the IRS publishes revenue rulings in its official bulletins. Taxpayers and IRS employees may rely on these published rulings as precedent. However, before publication, all identifying information is deleted from the proposed revenue ruling, facts may be altered to conceal identity, the position of the Service may be changed, and this sanitized version is subject to extensive administrative review.

In 1974, the Technical Office of the National Office handled 28,346 ruling requests. Approximately one-half of these (14,329) dealt with requests for changes in accounting periods and methods; these re-

[1] Statement of Procedural Rules § 601.201; Rev. Proc. 72–3, 1972–1 Cum. Bul. 698, modified by Rev. Proc 73–7, 1973–1 Cum. Bul. 776. However, the IRS will not rule on all transactions. For example, the IRS will not rule on whether compensation is reasonable in amount or on whether a taxpayer who advances funds to a charitable organization and receives a promissory note therefore may deduct as contributions amounts of the note forgiven by the taxpayer in later years. Rev. Proc. 72–9, 1972–1 Cum. Bul. 718. In addition, in some cases, the IRS has established guidelines describing the form of a transaction must take before a favorable ruling will be issued. See, e.g. Rev. Proc. 75–21, 1975–1, Cum. Bul. 715, which sets out conditions which a transaction must meet before a favorable ruling will be granted that a transaction is a leveraged lease and not a conditional sale.

[2] While an erroneous ruling issued to a taxpayer may be modified or revoked, generally (in the absence of an omission or misstatement of material facts or change in law) an advance letter ruling which is relied upon by the taxpayer in good faith will not be modified or revoked retroactively if the facts which subsequently develop are not materially different from the facts on which the ruling was based. Statement of Procedural Rules § 601.201(1)(5).

quests are handled rapidly and normally do not involve any substantive issue of general interest.[3]

Of the remaining rulings in 1974, the Technical Office responded to 14,017 taxpayer ruling requests. These ruling requests were on the following general subjects:

Subject	*Taxpayers' requests*
Actuarial matters	1,019
Administrative provisions	42
Employment and self-employment taxes	423
Engineering questions	69
Estate and gift taxes	317
Exempt organizations	4,120
Other excise taxes	421
Other income tax matters	6,196
Pension trusts	1,410
Total	14,017

The National Office of the IRS also will answer requests for advice from the district offices on issues that arise in the course of an audit of a taxpayer's return. This advice is in the form of a technical advice memorandum. Technical advice memoranda are addressed to a field office of the IRS but have an effect similar to that of a private letter ruling in that the technical advice involves a determination of tax questions concerning a particular taxpayer who generally has a right to, and usually does, participate in the technical advice proceeding. In 1974, the IRS handled 1,602 requests for technical advice.

In 1974, the IRS published 626 revenue rulings in its official bulletin. The source of these revenue rulings was both private rulings and technical advice memoranda. In one of the areas of tax law generally considered to be very complex—that of corporate reorganizations—the IRS published 25 rulings in 1974. In that same year, there were approximately 2,000 private rulings issued in the corporate reorganization area.

The Freedom of Information Act (FOIA) (5 U.S.C. § 552) became effective on July 4, 1967. The FOIA requires each agency to make available for public inspection and copying "interpretations which have been adopted by the agency * * *." (5 U.S.C. § 552(a)(2)(B).) However, there are a number of exceptions from the requirement of disclosure under the FOIA, including matters that are specifically exempted from disclosure by statute. (5 U.S.C. § 552(b)(3).)

Recently, the courts have considered the issue of whether private rulings are exempt from disclosure under the FOIA because they constitute tax returns (or return information) under the Internal Revenue Code (secs. 6103 and 7213). In these cases, both the United States Court of Appeals for the District of Columbia and the United States Court of Appeals for the Sixth Circuit held that private letter rulings were not covered under secs. 6103 and 7213 of the Code and were subject to disclosure under the FOIA. *Tax Analysts & Advo-*

[3] Under the Code, generally a taxpayer who changes his period or method of accounting must, before computing his taxable income under the new method, secure the consent of the IRS. (Secs 442 and 446(e).)

cates v. *Internal Revenue Service*,[4] and *Fruehauf Corp.* v. *Internal Revenue Service*.[5]

In addition, in *Fruehauf*, the court held that technical advice memoranda were to be open to inspection to the extent intended for issuance to a taxpayer. However, in *Tax Analysts*, the court held that a technical advice memorandum was not open to inspection, being a part of a tax return and therefore exempt from disclosure under the FOIA (by reason of secs. 6103 and 7213 of the Code).

In 1975, a suit was brought under the FOIA to compel release of all private letter rulings issued by the IRS since July 4, 1967, the effective date of the FOIA. *Tax Analysts & Advocates* v. *Internal Revenue Service*, Civil Action No. 75–0650 (D.D.C.), filed April 28, 1975.

On December 10, 1974, the IRS issued proposed procedural rules dealing with the publication of private rulings. In general, these proposed rules provided for public inspection beginning approximately 30 days after the issuance of the ruling. (Furthermore, in certain cases, a delay in public inspection could be granted for an additional period not to exceed 13 weeks.) Under these proposed rules, the IRS would make available for public inspection the full text of private rulings, including identifying information. However, these proposed rules provided procedures for protecting trade secrets and certain matters relating to national defense or foreign policy.

On March 25, 1975, the IRS held public hearings on these proposed rules, at which time there was substantial public comment. In addition, the IRS was informed by the Justice Department that at least one part of the proposed rules (dealing with "required rulings") might be contrary to other principles of law.

Reasons for change

Although the private rulings procedure had significant advantages for both the IRS and taxpayers, the system also contained some substantial problems. It has been argued that the private ruling system developed into a body of law known only to a few members of the tax profession. For example, an accounting or law firm with offices in Washington could have a library of all the private ruling letters issued to its clients. Such a firm was in a position to advise other clients as to the current IRS ruling position because of its special access to these rules of law. This, in turn, tended to reduce public confidence in the tax laws. Additionally, the secrecy surrounding letter rulings generated suspicion that the tax laws were not being applied on an even-handed basis.

These types of concerns led to the lawsuits described above to open private rulings to public inspection. While two courts have held private rulings to be open to public inspection, significant additional questions were raised since these court decisions. These questions concerned the parts of a ruling file that should be published, whether private rulings should be available as "precedent" for other taxpayers, what procedures should be established to allow taxpayers to claim that protected material should not be disclosed, etc.

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[4] 505 F. 2d 350 (D.C. Cir. 1974).
[5] 522 F. 2d 284 (6th Cir. 1975), petition for cert. granted Jan. 12, 1976.

The foregoing questions generally applied to future as well as to past rulings. There were additional questions concerning past rulings, however, because taxpayers who previously obtained rulings applied for them in reliance on the IRS position that the information submitted to the IRS would be treated as confidential tax information.

The Congress agrees with the previous court decisions that private rulings should be made public. Only in this way can all taxpayers be assured of access to the ruling positions of the IRS. Also, this tends to increase the public's confidence that the tax system operates fairly and in an even-handed manner with respect to all taxpayers. However, the Congress believes that the problems described above should be resolved by legislation, since the courts have not previously been given guidance by the Congress on these difficult issues in the tax field.

The problems should be resolved so that the public will have an exclusive remedy with respect to the disclosure of rulings and related material.

Explanation of provision

Under the Act, IRS written determinations (*i.e.*, rulings, technical advice memoranda, and determination letters) will generally be open to public inspection; that is, they will be made available for public inspection and copying in a public reading room in or near the issuing office. A complete set of IRS rulings and technical advice memoranda will be made available in a central public reading room in Washington, D.C. It is intended that a subject-matter index will also be placed in the public reading rooms. This index will classify rulings, etc., on the basis of the Code sections and issues involved. (It is anticipated that, as is presently the case with respect to other aspects of the tax law, various commercial services will make pertinent parts of this material available to people located elsewhere.) However, it is not contemplated that existing IRS indices will be disclosed.

Generally, any written determination issued by the IRS (including written determinations issued at the District Director's level as well as National Office rulings) is to be open to public inspection under the Act. Generally, a written determination will not be considered a ruling, technical advice memorandum, or determination letter unless it recites the relevant facts, explains the applicable provisions of law, and shows the application of the law to the facts. Thus, documents such as a notice of deficiency (sec. 6211), reports on claims or refund, or similar documents required to be issued by the IRS in the course of tax administration will not be considered rulings. Public inspection will apply only to a written determination actually issued to a person pursuant to his request and to a written determination (such as a technical advice memorandum) requested by an IRS employee in the course of an audit, tax collection, or similar proceeding. Public inspection will not apply to unissued written determinations or background information with respect to them.

Moreover, the Act does not provide for the public inspection of technical advice memoranda issued in connection with fraud and jeopardy proceedings until after such proceedings are completed.

Additionally, the Act does not require public disclosure of a closing agreement entered into between the IRS and a taxpayer which finally determines the taxpayer's tax liability with respect to a taxable year. (Where it is in the interest of a taxpayer and the IRS, a closing agreement may be made in order to provide certainty as to a person's past tax liability.) The Congress understands that a closing agreement is generally the result of a negotiated settlement and, as such, does not necessarily represent the IRS view of the law. The Congress intends, however, that the closing agreement exception is not to be used as a means of avoiding public disclosure of determinations which under prior practice, would be issued in a form which would be open to public inspection under the committee amendment.

Similarly, the Act does not apply to an IRS decision to accept a taxpayer's offer in compromise under a special procedure designed to permit the compromise of disputed issues. Summaries of accepted offers in compromise were open to public inspection under prior law. (The Act does not in any way change these provisions.)

The Act also does not apply to IRS determinations issued after September 2, 1974 as to whether a pension, profitsharing, etc., plan, an individual retirement account or an individual retirement annuity qualifies under the tax law, or as to whether an organization is tax-exempt, because these determinations were generally open to public inspection under prior law (sec. 6104(a)(1)). Also, the Act specifically requires the disclosure (sec. 6104) of determination letters with respect to applications filed after October 31, 1976, issued to an organization described in section 501 (c) or (d) with respect to its tax-exempt status.

Generally, the text of a determination, after having been sanitized so that there are no identifying details, is to be made open to public inspection. Identifying details consist of names, addresses, and any other information which the Secretary determines could identify any person, including the taxpayer's representative. In some situations, information included in a determination (other than a name or address) may not identify a person as of the time the determination is made open to public inspection, but that information, together with information that is expected to be disclosed by another source at a later date, will serve to identify a person. Consequently, in deciding whether a determination contains identifying information, the Secretary is to take into account information that is available to the public at the time that the determination is made open to public inspection as well as information that is expected to be publicly available from other sources within a reasonable time after the determination is made open to public inspection.

Generally, it is intended that the standard the IRS is to use in determining whether information will identify a person is a standard of a reasonable person generally knowledgeable with respect to the appropriate community.[6] The standard is not, however, to be one of a person with inside knowledge of the particular taxpayer.

Before any written determination requested after October 31, 1976, is made available for public inspection, any person who receives a

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[6] The appropriate community could be, e.g., an industry or a geographical community and will vary for the problem involved. For example, the "community" for a steel company will be all steel producers, but may also be the locale in which, e.g., the main plant is to be located if the determination deals with a land transaction.

ruling or determination letter or to whom a technical advice memorandum pertains must be personally notified in writing that public disclosure is about to occur. It is intended that this notification be made at the time the written determination is issued. Such person will then have 60 days within which to discuss with the IRS the information to be made available for public inspection and to bring a suit to restrain disclosure. It is expected that the IRS will develop administrative procedures which will facilitate the settlement of disputes without litigation. It is also expected that the IRS will not make any written determination open to public inspection before it advises the person to whom it pertains, in writing, as to any deletion which he has requested but with which the IRS disagrees. Moreover, the IRS may not make any written determination available for public inspection until 15 days after the initial 60-day period has expired, but it must make the written determination available no later than 30 days after such initial 60-day period has expired if no court proceedings are commenced. Such 60-day period will start on the date the IRS actually mails a notice to the person to whom the determination pertains, indicating that the written determination that he received is about to be made public. If any court action is commenced during such 60-day period to challenge the decision of the IRS with respect to disclosure, the IRS may not make the disputed portion of the written determination open to public inspection until after a final court decision.

In order to protect against impropriety and undue influence in the rulings, etc., process, the Act establishes a flagging procedure with respect to written determinations requested after October 31, 1976. If a particular determination is the subject of a contact (written or otherwise) by anyone other than the taxpayer or his representative before the determination is issued, the IRS will be required to note that fact at the time the determination is made public, by noting the date of the contact and by identifying the nature of the contact by category, e.g., White House, Congressional, Department of the Treasury, trade association, etc. It is expected that the IRS will make a written notation of all telephone contacts from outside parties with respect to a particular written determination. Contacts made by an employee of the IRS are not to be noted. For this purpose employees of the Office of Chief Counsel of the IRS are to be considered employees of the IRS. In addition, contacts made by the Chief of Staff of the Joint Committee on Taxation are not to be noted.

Communications concerning a pending determination from another agency which provides assistance to the IRS upon its request are also not to be flagged. Moreover, internal memoranda within the Internal Revenue Service relating to a particular written determination, or the question involved therein, which relate to development of the Service's legal position on the question involved, should not be a part of the background file (and for this purpose Chief Counsel should be considered part of the Internal Revenue Service). However, correspondence which seeks to elicit further factual information, and the response thereto, will not be excluded from the background file by the previous sentence (for example, in a case where the National Office seeks further information regarding a district director's request for technical advice). Because of their similarity to internal memoranda and attorneys work product, correspondence between the Internal Revenue Service and the Department of Justice regarding a particular civil or criminal investigation or case, which is related to a particular written determination, or with respect to the relationship of a determination to any civil or criminal investigation or case, shall not be considered part of the background file. (The question of the availability of these documents is to be governed by other provisions of law, including the Freedom of Information Act.)

If any person wishes to obtain further information regarding the identity of the contacting party and the nature of the contact, he may request access to the IRS background files. Upon payment of the charges for search, deletion and copying (subject to provisions for a reduction or waiver of these charges where the disclosure is in the public interest), the IRS will be required to make available to the third party information in the background file pertaining to the contact made, including the name of the contacting party and the person to whom the contact was addressed. Moreover, if a third party wishes to learn the identity of the applicant for the written determination, he may bring suit in the Tax Court or the United States District Court for the District of Columbia. The identity of the applicant may not be disclosed unless the court finds evidence in the record from which one could reasonably conclude that an impropriety occurred or that undue influence was exercised, and if the court finds that the disclosure would be in the public interest.

The Act, in addition to providing for the deletion of identifying details from determinations made available for public inspection, adopts in general the exemptions from public disclosure under the FOIA.

As part of the procedure for obtaining an IRS determination, a taxpayer is required to submit detailed revelant factual information for IRS consideration. Frequently, this information is repeated in the IRS determination. The Congress is concerned that if a taxpayer's confidential information necessary for an IRS determination is open to public inspection, the taxpayer may be injured financially or by loss of his personal privacy. As a consequence, taxpayers may become reluctant to request an IRS determination (even though their names will be deleted from the material made public).

The Congress does not intend that the IRS ruling program should be hindered by public disclosure. The ruling program benefits both taxpayers and the IRS (which obtains advance information about transactions through the ruling program). The Act therefore, provides that trade secrets and commercial or financial information obtained from a person and privileged or confidential is not to be publicly disclosed. However, in determining the information to be deleted, the IRS, except where the item to be disclosed relates to a trade secret, is directed to take into account the fact that generally, the identity of the taxpayer will not be made public.

Where the structure of a transaction is disclosable but disclosure of the amounts involved is not allowed under this rule, the Congress believes that in normal circumstances the application of the tax law can be fully demonstrated by using "artificial" numbers, for example, by substituting $8X and $9X for $400 and $450.

The Act also provides for the deletion of information the disclosure of which would constitute an unwarranted invasion of personal privacy. Under this provision, matters including (but not limited to) a pending (but not yet public) divorce; medical treatment for, *e.g.*, cancer; adoption of a child; or the amount of an individual's gift usually will be protected.

The Act, following the FOIA exceptions, provides for the deletion of matters that are specifically required by Executive order to be kept secret in the interest of the national defense or foreign policy, and which are in fact properly classified pursuant to the Executive order; geological and geophysical information and data, including maps, concerning wells; and matters contained in or related to examination, operating or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions. This last exception is needed *e.g.*, to protect the standing of financial institutions. For example, a regulatory agency may issue a confidential report requiring such an institution to classify a loan as a bad debt. Subsequently, the IRS may be called upon to determine whether the loan should be treated as a bad debt for tax purposes. The IRS may, of course, take the agency's report into account in deciding upon the proper tax treatment of the item. The Congress believes, however, that the banking agency's report should not be publicly disclosed by the IRS determination because it may damage the standing of the bank. Consequently, the Act provides for deletion of this type of information contained in the reports of such agencies.

Additionally, the Act requires deletion of information which is exempt from disclosure under another Federal statute which applies to the IRS. In some cases, a statutory nondisclosure provision applies only to a particular agency; in other cases, such a provision may apply to all agencies. Under the Act, information submitted to another Federal agency by a person under a nondisclosure rule applicable only to that agency would not be exempt from disclosure by the IRS merely because that person also submitted the information to the IRS. Of course, if the IRS obtained the information directly from the other agency under a nondisclosure rule of that agency, it would not be subject to disclosure by the IRS.

However, if in an action for disclosure of the identity of an applicant for a written determination, the court determines that disclosure of identity is appropriate, it may also, under appropriate circumstances, direct the IRS to make public any portion of the material deleted under the exemptions provided by the Act.

Under the Act, disclosure is not limited to the written determination alone. Although initially only the determination will be made available, the background file may be obtained by the public upon request, after payment of charges for search, deletion of identifying details, and copying. However, these charges may be reduced or waived where disclosure is in the public interest, and it is anticipated that no further charge will be made for deletions in the case of a subsequent request for the same background file document. Background files need not be made available for public inspection and copying in a public reading room.

Aside from the request for a determination, the background file includes, but is not limited to, correspondence between the IRS and the taxpayer and third party submissions. However, background files will not be available for public inspection with respect to general written determinations issued prior to July 4, 1967.

Also, the Act recognizes that, under some circumstances, it serves no purpose to disclose written determinations dealing with changes of accounting methods or taxable years, which are almost always routine. Therefore, an IRS determination regarding approval of the change of a taxpayer's taxable year or accounting method, of the accounting year or funding method of a qualified pension, etc., plan, or of a partner's or partnership's taxable year must be disclosed only if the IRS regards it as a guideline. Routine determinations in this area, together with background information, will be subject to disclosure only if the determination is requested after October 31, 1976, and, then, only if the third party seeking such a determination pays the charges for search, deletions, and copying.

Information which is contained in a written determination or background file document, but which is not made open to public inspection under the new rules, is treated as "return information" and subject to the nondisclosure rules of section 6103.

Under prior administrative rules, a private letter ruling, technical advice memorandum, or determination letter was not to be used as a precedent by the IRS or any person. If all publicly disclosed written determinations were to have precedential value, the IRS would be required to subject them to considerably greater review than is provided under present procedures. The Congress believes that the resulting delays in the issuance of determinations would mean that many taxpayers could not obtain timely guidance from the IRS and the rulings program would suffer accordingly. Consequently, the Act codifies the prior administrative rules by providing that determinations which are required to be made open to public inspection are not to be used as precedent. Thus, if the IRS issued a written determination to a taxpayer with respect to a specified transaction which occurred in a particular year, and that taxpayer or any other taxpayer engages in the same transaction in a subsequent year, the earlier determination could not be used by the taxpayer or the IRS as a precedent for the subsequent year unless the determination specifies that it applies to a series of such transactions.

However, under the Act, the IRS may designate in a widely circulated official government publication (such as the Internal Revenue Bulletin) determinations which will be used as precedent, except that the precedential value, if any, of excise tax determinations will remain the same as under prior law.

The Act relates to the disclosure of all rulings, technical advice memoranda, and determination letters, whether or not issued after July 4, 1967. However, certain rules to determine the order in which disclosure is to occur are provided in the case of those rulings, etc., requested prior to November 1, 1976. In general, no such rulings, etc., will be available prior to the prescribed time. Contingent upon the availability of funds specifically appropriated to the IRS for the purpose of making prior determinations open to public inspection, the

IRS is directed to release, on a last-in, first-out basis, all prior determinations issued under the 1954 Code which have been used by the IRS as guidelines for other determinations. Thereafter, the IRS is directed to release, on the same basis, all prior non-guideline determinations (other than non-guideline determination letters) issued after July 4, 1967. Third, the IRS is directed to release, on a last-in, first-out basis, all prior determinations issued under the internal revenue laws as in effect prior to the 1954 Code which have been used by the IRS as guidelines for other determinations. Finally, determinations issued on or before July 4, 1967 will not be formally released by the IRS, although they will be available upon request after they are made open for public inspection, but only upon payment of charges for search, deletion, and copying. In no event, however, is the disclosure of IRS written determinations under pending court actions to be delayed under the above rides.

The Act includes a records disposal provision, to enable the IRS to follow its normal records disposition procedures. The IRS may not dispose of any written determination which it uses as a guideline for other determinations. The IRS may dispose of any other written determination requested after October 31, 1976 not earlier than 3 years after the document is first made available to the public. For general written determinations requested prior to November 1, 1976, however, the Act extends the retention date to January 20, 1979. Moreover, if funds are appropriated so that the IRS will be able to make prior determinations open to public inspection, the IRS will be unable to dispose of such prior determinations earlier than 3 years after the document is first made available to the public. This record retention provision in the Act relates not only to a written determination but also to the related background file.

It is anticipated that the IRS is to establish a special temporary unit for the purpose of making prior determinations open to public inspection and that this unit is to be phased out as these prior determinations are made public.

Under the Act, the IRS is to issue notice in the *Federal Register* of the application of the new disclosure rules to prior determinations requested before November 1, 1976, and the intent to make them public. It is understood that a notice may relate only to a limited category of determinations (for example, determinations issued between July 4, 1967, and December 1, 1967). No part of such a prior determination is to be made open to public inspection under these rules before the expiration of 90 days following the notice in the *Federal Register.* If any court action is commenced during the first 75 days within such 90-day period to challenge the decision of the IRS with respect to disclosure, the IRS may not make the disputed portion of the written determination open to public inspection until after a final court decision.

Generally, a written determination which is required to be made open to public inspection under the Act is to be placed in a public reading room in or near the office where issued (such as the National Office or the District Office, where appropriate) no earlier than 75 days and no later than 90 days after the IRS actually notifies the person who receives any ruling or determination letter or to whom a technical advice memorandum pertains of the impending disclosure. However, prior determinations may not be made open to public inspection until 90-days after publication of the required notice in the *Federal Register*. Moreover, in the event of litigation, disclosure is to be made within 30 days after the final determination, unless an extension is granted by the court.

In order to prevent interference with pending transactions, however, the Act provides for public inspection to be delayed where necessary until the completion of a transaction involved in the determination. Under this provision, disclosure may be delayed (for an initial period of up to 90 days) until 15 days after the Secretary determines that the transaction is completed. The first extension is to be automatic on a showing that the transaction will not be completed until the period in question has passed. A second extension (up to an additional 180 days) could be granted where the transaction is not complete at the end of the initial period and the Secretary determines that there is good cause for delay. The burden of showing good cause is to be on the person requesting the delay. The second extension would expire not later than 15 days after the date of the Secretary's determination that the transaction is complete. Thus, if both extensions are allowed for the completion of a transaction, the determination is to be made open to public inspection within 360 days after it is issued.

If a written determination and related background file is made open for public inspection and the IRS intentionally or willfully fails to delete any information required to be deleted or to follow the prescribed disclosure procedures, the recipient of the written determination or any person identified in the written determination may bring a civil action in the Court of Claims for damages.

If agreement cannot be reached between the Secretary and the person who receives a ruling or determination letter or to whom a technical advice memorandum pertains as to the extent of public disclosure, and administrative remedies have been exhausted, the person involved may petition the Tax Court for a decision as to whether the disputed portion of the IRS determination or background file document is properly open to public inspection under the new rules. If such a petition is not filed, the Secretary is to make the determination or document open to public inspection under the new rules in accordance with his fidings, within the time period described above.

A petition must be filed with the Tax Court before the IRS determination or background file document has been made open to public inspection under the new rules. A petition is to be served on the Secretary, and within 15 days after the petition is served on him, the Secretary is to notify (by registered or certified mail) any person to whom the determination pertains (other than the petitioner) of the filing of the petition. Once a person has received a notice of the filing of the petition, he may intervene in the case but he may not thereafter file a petition himself. (This will ensure that all issues of confidentiality raised before public inspection is allowed and arising out of a single IRS determination are heard in one action before the Tax Court.) The Tax Court proceedings could be *in camera* to the extent necessary to preserve protected information from being disclosed as a result of the proceedings. The Tax Court will be required to make a decision in the case at the earliest practicable date and expedited in every way.

It is expected that the rules of the Tax Court will permit disclosure cases to be heard at the same locations at which tax cases are heard and additionally will permit any disclosure case under the amendment to be heard in Washington, D.C. The burden in the case will be on the person seeking to restrain disclosure.

A decision of the Tax Court in such a case could be appealed only to the United States Court of Appeals for the District of Columbia unless the Secretary agrees with the person involved to review by another court of appeals (sec. 7482(b)). The IRS determination will be made open to public inspection solely in accordance with a final decision of the Tax Court, except to the extent that additional disclosure is required in a later action to obtain additional public disclosure (discussed below).

A special procedure is provided for third parties to obtain additional disclosure of an IRS written determination or background file document (or portion thereof) which has not been made open to public inspection. This is required so that independent third parties can challenge IRS decisions as to what part of a written determination or document is to be made public. A person seeking additional disclosure of an IRS written determination or background file document is to submit a written request for the information to the IRS. The Secretary is to provide administrative remedies for a person seeking greater disclosure. After exhausting such remedies, the person seeking additional disclosure could petition the Tax Court or file a complaint in the District Court for the District of Columbia to compel additional disclosure. It is expected that the rules of the Tax Court will prove that the actions may be brought at the same locations at which tax cases are heard and at Washington, D.C., and that rules will be developed to prevent subsequent relitigation with respect to the same written determination or document. No action to compel additional disclosure of a written determination could be brought more than 3 years after any portion of the determination is made open to public inspection under the new rules.

The court is to examine the matter *de novo* and without regard to a decision to restrain or permit disclosure in any court action between the IRS and a person involved in the written determination or related background file document. The proceedings will be subject to the same rules that would apply under the FOIA if the proceeding were brought under the FOIA on the date of enactment of the bill. Thus, for example, the IRS will generally be required to file its answer within 30 days after the petition or complaint is filed, the case will have a high priority on the docket of the court, the petitioner or complainant could be awarded costs where he substantially prevails in the action, disciplinary proceedings could be commenced against IRS employees in appropriate cases, and failure to comply with a court order compelling additional disclosure could be punished under contempt rules. As under the FOIA, the burden will be on the Secretary or other parties seeking to prevent additional disclosure.

Additionally, where a petition or complaint is filed to compel additional disclosure, the Secretary is to notify any person identified by name and address in the written determination within 15 days after the petition or complaint is served on the Secretary. Such person and any person to whom such written determination pertains could intervene in the case. After sending the notice, the Secretary will not be required to defend the case and would not be liable on account of disclosure of the determination (or any portion thereof) in accordance with a final decision of the court.

A decision of the Tax Court in such a case could be appealed only to the United States Court of Appeals for the District of Columbia unless the Secretary agrees with the person involved to review by another court of appeals (sec. 7482(b)).

The public inspection of rulings, technical advice memoranda, and determination letters and related background files could be accomplished only pursuant to the rules and procedures set forth in this section, and not those of any other provision of law, such as the FOIA. However, this section is not to be construed as excluding production pursuant to a discovery order made in connection with a judicial proceeding, or with respect to requests pending in the courts under the FOIA.

Effective date

The new rules apply after October 31, 1976.

Revenue effect

This provision has no effect on Federal revenues.

2. Disclosure of Tax Returns and Tax Return Information (sec. 1202 of the Act and sec. 6103 of the Code)

a. In general

Prior law

Under p ior law, all income tax returns were described as "public records." However, tax returns generally were open to inspection only under regulations approved by the President, or under Presidential order. This applied to returns concerning income tax, estate tax, gift tax, manufacturers excise taxes, the communications excise tax and the transportation excise tax.[1]

Additionally, the statute provided a number of specific situations in which tax returns could be disclosed. These statutory rules had been supplemented by a number of regulations and executive orders. The regulations were of two general types, those allowing inspection on a case-by-case basis and those allowing general inspection of tax returns. On a case-by-case basis, every Federal agency had access to tax returns on the written request of the head of the agency and, in most cases, in the discretion of the Secretary of the Treasury or the Commissioner. Under these "case-by-case" regulations, returns were made available to a number of agencies.[2]

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[1] Under the statute, income tax returns were open to inspection upon order of the President and under Treasury rules and regulations approved by the President (sec. 6103(a)(1)) and also were "open to public examination and inspection" to the extent authorized in rules and regulations established by the President. (Sec. 6103(a)(2).)

Estate and gift tax returns and miscellaneous excise tax returns also were open to inspection under rules and regulations established by the President.

[2] Disclosure of tax returns had been made under this provision, to the Civil Service Commission, the Department of Defense, the Federal Communications Commission, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the Federal Power Commission, the Federal Trade Commission, the Department of the Interior, the Interstate Commerce Commission, the National Labor Relations Board, the Post Office, the Small Business Administration, the Tennessee Valley Authority, the Department of Transportation, and the Veterans Administration. In many of these situations, only a few returns were involved. Generally, the returns were used for investigative purposes in connection with matters within the jurisdiction of the agency.

Also, returns were made available on a case-by-case basis to an attorney of the Department of Justice (or U.S. attorney) "where necessary in the performance of his official duties." Returns were also available to the Department of Justice for use in litigation in which the United States was interested in the result.

The regulations allowing general inspection of tax returns applied to a few specific agencies and provided that the agency in question could obtain tax returns for given purposes. Under these regulations, the agency in question did not have to specify the reason for inspection, the person who would inspect, etc. The amount of information disclosed under these regulations varied with the agency. In some cases disclosure occurred with respect to several thousand returns a year and in other cases (involving use for statistical purposes) disclosure of limited amounts of information regarding millions of taxpayers occurred each year.[3]

Reasons for change

The IRS probably has more information about more people than any other agency in this country. Consequently, almost every other agency that has a need for information about U.S. citizens sought it from the IRS. However, in many cases the Congress had not specifically considered whether the agencies which had access to tax information should have had that access.

The statutory rules governing the disclosure of tax information had not been reviewed by the Congress for 40 years. Since that time a number of rules allowing disclosure of tax information to other government agencies had been established by executive order and regulation.

Additionally, questions recently arose with respect to disclosure of tax information to the White House. Apparently, tax information had been obtained by the White House pertaining to a number of well known individuals for use for non-tax purposes. Also, tax returns had been provided White House employees in previous administrations.

Questions were raised and substantial controversy created as to whether the extent of actual and potential disclosure of returns and return information to other Federal and State agencies for non-tax purposes breached a reasonable expectation of privacy on the part of the American citizen with respect to such information. This, in turn, raised the question of whether the public's reaction to this possible abuse of privacy would seriously impair the effectiveness of our country's very successful voluntary assessment system, which is the mainstay of the Federal tax system.

In a more general sense, questions were raised with respect to whether tax returns and tax information should be used for any purposes other than tax administration.

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[3] Under the general inspection regulations, tax information was obtained by the Department of Health, Education, and Welfare to administer title II (old age. etc. benefits) of the Social Security Act (Regs. § 301.6103(a)–100); by the Securities and Exchange Commission for statistical purposes (Regs. § 301.6103(a)–102); by the Advisory Commission on Intergovernmental Relations for studying the coordination and simplification of the tax laws (Regs. § 301.6103(a)–103); by the Department of Commerce and the Renegotiation Board "in the interest of the internal management of the government" (Regs. § 301.6103(a)–104, 105); and by the Federal Trade Commission to aid in carrying out the Federal Trade Commission Act (Regs. § 301.6103(a)–106). Also, the regulations provided that standing committees of Congress could obtain tax information as authorized by executive order and resolution of the committee (Regs. § 301.6103(a)–101).

Recent Congressional action with respect to privacy in general has had an impact on the disclosure of tax information. (Privacy Act of 1974, Public Law 93–579). However, the Congress did not specifically focus on the unique aspects of tax returns in the Privacy Act.

The Congress reviewed each of the areas in which returns and return information were subject to disclosure. With respect to each of these areas, the Congress strove to balance the particular office or agency's need for the information involved with the citizen's right to privacy and the related impact of the disclosure upon the continuation of compliance with our country's voluntary tax assessment system.

Although prior law describes income tax returns as "public records" open to inspection under regulations approved by the President or under Presidential order, the Congress felt that returns and return information should generally be treated as confidential and not subject to disclosure except in those limited situations delineated in the newly amended section 6103 where it was determined that disclosure was warranted.

Explanation of provision

The Act provides that as the general rule returns and return information are to be confidential and not subject to disclosure except as specifically provided in section 6103 or other sections of the Code. Only those regulations now in effect and subsequently promulgated by the Secretary which interpret a specific provision of section 6103 are to continue to have force and effect after the effective date of this section of the Act. Consequently, those regulations promulgated under Presidential authority prior to the effective date of this section of the Act which do not interpret any specific provision of this section are no longer to have any force and effect after the effective date of this section of this Act.

Under the Act, section 6103 applies to the disclosure of a "return" or "return information." "Return" is defined to mean any tax or information return, declaration of estimated tax or claim for refund which, under the Code, is required (or permitted) to be filed on behalf of, or with respect to, any person. It also includes any amendment, supplemental schedule or attachment filed with the tax return, information return, etc. However, a "written determination" (as defined under section 6110(b)) which is included with or attached to a return filed by a taxpayer is not to be considered a return.

The term "return information" is to include the following data pertaining to a taxpayer: his identity, the nature, source or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments and tax payments. It also includes any particular of any data, received by, recorded by, prepared by, furnished to, or collected by the IRS with respect to a return filed by the taxpayer or with respect to the determination of the existence, or possible existence, of liability (including the amount of liability) for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense provided for under the Code. A summary of data contained in a return would constitute return information. Information as to whether a taxpayer's return was, is being, or will be examined or subject to other investigation or processing is also to be considered return information. Return information is to include any part of any "written determination or any background file document relating to such written determination" (as these terms are defined in section 6110(b)) which is not open to public inspection under section 6110.

Return information is not to include data in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer. Thus, statistical studies and other compilations of data now prepared by the IRS and disclosed by it to outside parties will continue to be subject to disclosure to the extent allowed under prior law. Thus, for research purposes, the IRS can continue to release statistical studies and compilations of data, such as the tax model, which do not identify individual taxpayers. The definition of "return information" was intended to neither enhance nor diminish access now obtainable under the Freedom of Information Act to statistical studies and compilations of data by the IRS. Thus, the addition by the IRS of easily deletable identifying information to the type of statistical study or compilation of data which, under its current practice, has been subject to disclosure, will not prevent disclosure of such study or compilation under the newly amended section 6103. In such an instance, the identifying information would be deleted and disclosure of the statistical study or compilation of data could be made.

"Taxpayer return information" is return information which is filed with or furnished to the IRS by or on behalf of the taxpayer to whom the return information relates. This includes, for example, data supplied by a taxpayer's representative (e.g., his accountant) to the IRS in connection with an audit of his return. It would also include any data received by the IRS from a taxpayer's representative pursuant to an administrative summons which was issued in connection with an IRS civil or criminal tax investigation of the taxpayer. It would not include "taxpayer identity", defined below, where the taxpayer identity was received from a source other than the taxpayer or his representative; this would be the case notwithstanding that the same taxpayer identity data was also furnished by the taxpayer or his representative.

The term "taxpayer identity" means the name of a person with respect to whom a return is filed, his mailing address, and his taxpayer identifying number (as defined in section 6109), or a combination thereof.

The term "disclosure" means the making known to any person in any manner whatever, including inspection, a return or return information. The terms "inspected" and "inspection" mean any examination of a return or return information.

b. Disclosure to Congress

Prior law

Under prior law, congressional committees fell into three categories for disclosure purposes. The tax committees inspected tax information in executive session. Select committees of the House and Senate inspected tax information, in executive session if specifically authorized to do so by a resolution of the appropriate body. Standing and select committees inspected tax information under an executive order issued by the President for the committee in question and on the adoption of a resolution (by the full committee) authorizing inspection. The resolution was required to set out the names and addresses of the taxpayers in question and the periods covered by the returns to be inspected. Subcommittees inspected tax information under an executive order and resolution of the full committee. The designated agents of any authorized committee also inspected tax information.

Under prior law, the tax committees and select committees authorized to inspect tax information were permitted to submit "any relevant or useful" information obtained to the House or Senate.

Reasons for change

While the Congress, particularly its tax-writing committees, requires access in certain instances to returns and return information in order to carry out its legislative responsibilities, it was decided that the Congress could continue to meet these responsibilities under more restrictive disclosure rules than those provided under prior law.

Explanation of provision

Under the Act, the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation, upon written request of their respective chairmen, would continue to have access to returns and return information. However, returns and return information would be required to be received in a closed executive session unless the returns and return information would not identify a taxpayer or that taxpayer consented in writing to the disclosure of his identity.

The Chief of Staff of the Joint Committee on Taxation is to have access to returns and return information without first obtaining a delegation of that authority from the Joint Committee on Taxation. The Chief of Staff is to have the right to submit any relevant or useful information to any of the tax-writing committees, but only in closed executive session unless the returns and return information would not identify a taxpayer or that taxpayer consented in writing to the disclosure of his identity.

The nontax committees are to be furnished returns and return information in closed executive session upon (1) a committee action approving the decision to request such returns, (2) an authorizing resolution of the House or Senate, as the case may be, and (3) the written request by the Chairman of the committee on behalf of the committee for disclosure of the returns or return information. The resolution of the appropriate body authorizing these committees to obtain returns or return information would specify the purpose for inspection and that inspection was to be made only if there was no alternative source of information reasonably available to the committee. The committees, through the committee Chairman and ranking minority member, could designate no more than 4 agents (2 majority and 2 minority) to inspect the returns or return information requested.

The tax-writing committees could submit relevant return information to the Senate or House, as the case may be. The nontax-writing committees could submit such return information to the Senate or House sitting in closed executive session.

The Joint Committee on Taxation could submit tax information to the Committee on Ways and Means or to the Committee on Finance sitting in closed executive session. However, a closed executive session would not be required if a taxpayer were not identified or if the taxpayer consented in writing to the disclosure of his identity.

c. White House (and other Federal Agencies)

Prior law

The Code did not specifically provide for disclosure of tax returns or return information to the President. However, the Code did provide that disclosure could be made as authorized in rules and regulations established by the President. Under this provision, the President could issue a "rule or regulation" providing for his access, and that of White House employees, to tax information. Additionally, in a previous administration, the then-Chief Counsel of the IRS informed the Commissioner in a legal opinion that, as a constitutional matter, there were no restrictions on the Commissioner disclosing tax information to the President. This interpretation was based on that part of the Constitution which vests executive power in the President and, on this basis, it was contended that he was entitled to all information relative to his control of the Executive Branch.

Under Executive Order 11805, September 20, 1974, tax returns were available for inspection by the President. Requests for inspection were to be in writing and signed by the President personally. Requests were to state the name and address of the taxpayer in question, the kind of returns which were to be inspected, and taxable periods covered by the returns.

Under this executive order, other White House employees also could obtain tax information. The order provided that the President could designate, by name, employees of the White House Office who could receive tax information. This was limited to employees with an annual rate of basic pay at least equal to that prescribed by 5 U.S.C. § 5316. No further disclosure (except to the President) could be made by such employees without the written direction of the President.

Reasons for change

The President needs certain tax information, particularly (if not entirely) in the "tax check" area. The Act, to a large extent, codifies Executive Order 11805, which, among other things, restricts access to tax information to a relatively limited number of people in the White House. Moreover, the Congress felt that the White House should report to the Congress regarding the disclosures of tax information made to it. Consequently, quarterly reporting requirements were imposed upon the White House. Similar requirements were also provided with respect to tax checks made by other Federal agencies.

Explanation of provision

Under the Act, upon the written request of the President, signed by him personally, disclosure of returns and return information is to be made to the President and/or to certain employees of the White House Office named in the request. A request is to specify the name and address of the taxpayer whose return is sought, the kind of return and return information sought, the taxable period or periods of such returns and return information, and the reason disclosure is requested.

The President and the head of a Federal agency (and designated employees) also may make a written request for a "tax check" with respect to an individual who is designated as being under consideration for appointment to a position in the Executive or Judicial Branch of the Federal Government. The "tax check" is limited to the inquiry as to whether an individual has filed income tax returns for the last 3 years, has failed in the current or preceding 3 years to pay any tax within 10 days after notice and demand, has been assessed a negligence penalty within this time period, has been or is under any criminal tax investigation (and the results of such investigation), or has been assessed a civil penalty for tax fraud. Within 3 days of the receipt of a tax check request, the IRS is to notify the individual who is the subject of the tax check of the identity of the requesting party (i.e., the White House or Federal agency involved) and the return information requested.

Disclosure of returns and return information under this provision is not to be made to any employee of the White House or Federal agency (other than personnel of the FBI when acting as agents for the White House or the Federal agency or necessary clerical personnel of the White House or agency) who does not earn the rate of compensation specified by section 5316 of title 5, United States Code. Moreover, these employees will not be allowed to disclose returns and return information to any other person except the President or the head of the agency, as the case may be, without the personal written direction of the President or the head of the agency.

The President and the head of any agency requesting returns and return information under this section will be required to file a report with the Joint Committee on Taxation within 30 days after the close of each calendar quarter. This report is to set forth the taxpayers with respect to whom the requests were made, the returns or return information involved, and the reasons for requesting such returns or return information. However, the President will not be required to report on requests for returns and return information pertaining to an individual who was an employee of the Executive Branch at the time the request was made. The reports will not be disclosed unless the Joint Committee on Taxation determines that disclosure of such reports (or parts of the reports) would be in the national interest. Thus, if the Joint Committee on Taxation determined that the White House or any Federal agency used the return or return information obtained under this section for improper political purposes, it would have the authority to make a report of this to the Congress.

The reports will be maintained by the Joint Committee on Taxation for a period not exceeding 2 years unless, within that period of time, it determined that a disclosure to the Congress was necessary.

d. Tax Cases

Prior law

Where the Justice Department was investigating a possible violation of the civil or criminal tax laws and the matter had not been referred by the IRS, a Justice Department attorney or U.S. Attorney could obtain tax information upon written application where it was "necessary in the performance of his official duties."

The Justice Department could obtain the returns of potential witnesses and third parties. Also, in a tax case (as well as any other case), the IRS would answer an inquiry from the Justice Department as to whether a prospective juror had been investigated by the IRS. However, other tax information was not made available for examining prospective jurors.

Tax information obtained by the Justice Department was subject to use in proceedings conducted by or before any department or establishment of the Federal Government or in which the United States was a party.

Tax returns obtained by the Justice Department generally pertained to the taxpayer whose civil or criminal tax liability was directly involved in the case. However, the Justice Department also obtained tax returns of potential witnesses for the taxpayer or Government and third parties with whom the taxpayer had had some transactional or other relationship.

The returns of witnesses generally were obtained for purposes of cross examination and impeachment. In many cases, the information obtained from the witness' tax return was used to cast doubt upon his credibility as a witness, as opposed to establishing the tax liability in issue.

Additionally, in the course of tax cases, the Justice Department obtained the returns of third parties who were not to be witnesses in the case, but who had a transactional relationship with the taxpayer involved in the case. In a criminal tax case, third-party returns were used to develop leads to evidence establishing the guilt of a defendant. In civil tax cases, third-party returns were used to develop evidence pertaining either directly to the tax liability of a taxpayer or to impeach the testimony of the party whose tax liability was at issue (or to impeach the testimony of witnesses testifying on his behalf).

The Government also obtained the tax returns of its own witnesses to determine the veracity of their proposed testimony and their credibility in general.

Reasons for change

The Justice Department must have continued access to tax returns and return information in order to carry out its statutory responsibility in the civil and criminal tax areas. While the Congress decided to maintain the present rules pertaining to the disclosure of returns and return information of the taxpayer whose civil and criminal tax liability is at issue, restrictions were imposed in certain instances at the pre-trial and trial levels with respect to the use of third-party returns where, after comparing the minimal benefits derived from the standpoint of tax administration to the potential abuse of privacy, it was concluded that the particular disclosure involved was unwarranted.

Explanation of provision

The Justice Department is to continue to receive returns and return information with respect to the taxpayer whose civil or criminal tax liability is at issue. The return or return information of a third party may be disclosed to the Justice Department in the event that the treatment of an item reflected on his return is or may be relevant to the resolution of an issue of the taxpayer's liability under the Code. Thus, for example, the returns of subchapter S corporations, partnerships, estates and trusts may reflect the treatment of certain items which may be relevant to the resolution of the taxpayer's liability because of some relationship (i.e., shareholder, partner, beneficiary) of the taxpayer with the corporation, partnership, estate, or trust. In cases involving the assessment of a penalty upon a person for failure to pay withholding taxes, the reflection of such items on a corporate return such as wages paid, taxes withheld, and the corporate office held by the person, may be relevant to the resolution of the issue of liability for the penalty. The treatment (or absence of treatment) of alleged loans and gifts on a return may also be relevant to the resolution of the issue in criminal fraud net worth cases.

The return or return information of a third party could also be disclosed to the Justice Department where the third party's return or return information relates or may relate to a transaction between the third party and the taxpayer whose tax liability is or may be at issue and the return information pertaining to that transaction may affect the resolution of an issue of the taxpayer's liability. For example, the treatment on a buyer's return regarding his purchase of a business would be relevant to the seller's tax liability resulting from the sale of the business. The buyer may be amortizing what he claims to be "a covenant not to compete," whereas the seller may be claiming capital gain treatment upon the alleged sale of "goodwill."

The return reflecting the compensation paid to an individual by an employer other than the taxpayer whose liability is at issue would not meet either the item or transaction tests described above in a reasonable compensation case. Thus, for example, the reflection on a corporate return of the compensation paid its president would not represent an item the treatment of which was relevant to the liability of an unrelated corporation with respect to the deduction it claims for the salary paid its president.

In section 482 cases (involving the reallocation of profits and losses among related companies), where it is sometimes necessary to determine the prices paid for certain services and products at arms-length between unrelated companies, the return or return information of a company which was unrelated to (and not transactionally involved with) the taxpayer company would not be disclosable under either the item or transaction tests described above.

The disclosure of a third party return in a tax proceeding (including the U.S. Tax Court) will be subject to the same item and transactional tests described above, except that such items and transactions must have a direct relationship to the resolution of an issue of the taxpayer's liability.

Only such part or parts of the third party's return or return information which reflects the item or transaction will be subject to disclosure both before and in a tax proceeding. Thus, the return of a third-party witness could not be introduced in a tax proceeding for purposes of discrediting that witness except on the item and transactional grounds stated above.

In those cases where the absence of the reflection of an item or transaction on a third party's return is or may be related (or directly related in a tax proceeding) to the resolution of an issue, the IRS would not be authorized to disclose the return, but would be authorized to verify in a written statement the absence of the reflection of the item or transaction.

The Secretary will have the discretion to refuse to disclose third party return information for purposes of use in a tax proceeding if he determines that the disclosure would identify a confidential informant or seriously impair a pending civil or criminal tax investigation.

Except in those instances where a tax matter was referred by the IRS to the Department of Justice, and tax refund cases under Subchapter B of Chapter 76, the Justice Department would be required to make a written request (by the Attorney General, the Deputy Attorney General, or an Assistant Attorney General) for the inspection or disclosure of returns and return information, setting forth the reasons for the disclosure or inspection. For purposes of this provision, the referral of a tax matter by the IRS to the Justice Department would include those disclosures made by the IRS to the Justice Department in connection with the necessary solicitation of advice and assistance with respect to a case prior to formal referral of the entire case to the Justice Department for defense, prosecution, or other affirmative action.

In tax cases, the Justice Department will be allowed to inquire of the IRS as to whether a prospective juror has been under an audit or investigation by the IRS. The IRS will only be allowed to respond affirmatively or negatively to that inquiry. The taxpayer whose civil or criminal tax liability is at issue (and his legal representative) in the case will have the same right to this limited disclosure.

e. Federal Agencies—Nontax Criminal Cases

Prior law

Under Treasury regulations, a U.S. Attorney or an attorney of the Justice Department could obtain tax information in any case "where necessary in the performance of his official duties." This was obtained on written application, giving the name of the taxpayer, the kind of tax involved, the taxable period involved, and the reason inspection was desired. The application was to be signed by the U.S. Attorney involved or by the Attorney General, Deputy Attorney General, or an Assistant Attorney General.

Tax information obtained by the Justice Department could be used in proceedings conducted by or before any department or establishment of the Federal Government or in which the United States was a party.

The IRS also answered inquiries from the Justice Department as to whether a prospective juror had been investigated by the IRS. However, other tax information was not available for examining prospective jurors.

Tax information obtained in Justice Department investigations was used in prosecuting criminal offenses. Thus, requests were made for tax information pertaining to the defendant and to defense witnesses in the course of the investigation, at the pretrial level, and sometimes during the trial. The returns of defense witnesses in nontax criminal trials were often requested to obtain information for cross-examination and impeachement of these witnesses. The tax returns of Government witnesses were also obtained in order to evaluate the veracity of their proposed testimony as well as to evaluate their credibility in general. Tax information was also obtained with respect to third parties who had some transactional or other relationship with the defendant in order to seek investigative leads.

During the calendar year 1975, there were 166 requests for tax information by strike forces (and an additional 62 by the Criminal Division) of the Justice Department. The strike force requests concerned 8,103 tax returns of 1,711 taxpayers.

As the chief law enforcement representatives of the Attorney General within their respective judicial districts, U.S. Attorneys are responsible for investigating and prosecuting persons who violate the Federal criminal laws. U.S. Attorneys have used tax information in investigating and prosecuting criminal activities. In calendar year 1975, U.S. Attorneys made 1,350 disclosure requests for tax information. These requests pertained to 17,678 tax returns of 4,330 taxpayers. It appears that a significant proportion of the requests made by U.S. Attorneys were for criminal investigative purposes. Most U.S. Attorney tax data requests for investigative purposes pertained to potential "white collar" crimes involving some form of corruption (e.g., bribery, illegal kickbacks) or "major fraud" (e.g., bank, investment, and mail frauds). Ordinarily, requests for tax returns were not made with respect to crimes of violence or for routine misdemeanor cases.

In connection with the enforcement of nontax criminal statutes (as well as nontax civil statutes), tax information was made available to each executive department and other establishments of the Federal Government (e.g., SEC and FTC) in connection with matters officially before them, on the written request of the head of the agency. Tax information obtained in this manner could be used as evidence in any proceedings before any "department or establishment" of the United States or any proceedings in which the United States was a party.

Reasons for change

The Congress believes that the American citizen is compelled by our tax laws to disclose to the IRS is entitled to essentially the same degree of privacy as those private papers maintained in his home. Prior law and practice did not afford him that protection—the Justice Department and other Federal agencies, as a practical matter, being able to obtain that information for nontax purposes almost at their sole discretion.

The Congress decided, therefore, that the Justice Department and any other Federal agency responsible for the enforcement of a nontax criminal law should be required to obtain court approval for the inspection of a taxpayer's return or return information. The court approval procedure would not be required, however, with respect to information which is derived from a source other than the taxpayer.

Explanation of provision

Under the Act, disclosure of a return or return information received from a taxpayer, subject to one exception noted below, would be made to a Federal agency for nontax criminal purposes only upon the grant of an *ex parte* order by a Federal district court judge. The order would be granted upon the determination of the judge that (1) there is reasonable cause to believe, based upon information believed to be reliable, that a specific criminal act has been committed, (2) there is reason to believe that the return or return information is probative evidence of a matter in issue related to the commission of the criminal act, and (3) the information sought to be disclosed cannot reasonably be obtained from any other source. Notwithstanding that the information sought can be reasonably obtained from another source, the third requirement described above would be inapplicable if the judge determined that the return or return information sought constitutes the most probative evidence of a matter in issue relating to the commission of the criminal act.

The first requirement set forth above ("reasonable cause . . .") is intended to be less strict than the "probable cause" standard for issuing a search warrant, and this requirement is to be construed according to the plain meaning of the words involved. The term "criminal act" includes any act with respect to which the criminal penalty provisions of a Federal nontax statute (which may also include civil penalty provisions) would apply.

In the case of the Justice Department, only the Attorney General, the Deputy Attorney General, or an Assistant Attorney General may authorize an application for an order. In the case of other Federal agencies, the head of the agency would be required to authorize an application.

This court procedure contemplates an *in-camera* inspection of the return or return information by the judge to determine whether any part or parts thereof meet these requirements. Only the part or parts of the return or return information determined by the court to meet these requirements would be subject to disclosure. In this regard, the more personal the information involved (for example, medical and psychiatric information), the more restrictive the court is to be in allowing disclosure.

In the event that the Secretary determines that a disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation, he would have the authority to withhold the requested return or return information from the court order procedure described above. This would be accomplished by a certification by the Secretary to the court of this determination. Proper implementation of this provision will necessarily involve notification of the IRS by the Justice Department or other agency prior to seeking the court order to provide the IRS with the opportunity to make the determination.

The IRS would be precluded under this subsection from disclosing return information indicating the commission of a crime to the Justice Department or any other Federal agency where the return information was supplied by the taxpayer or his representative. The Justice Department and other Federal agencies would only be able to obtain this information through the court approval procedure described above.

The IRS would not, however, be precluded from disclosing to the Justice Department or any other Federal agency information which is received from sources other than the taxpayer and his representatives.

It is contemplated that only in those situations where the information is clearly identified and segregable as being from sources other than the taxpayer would disclosure occur, and then, only in those instances where the information indicates the possible commission of a nontax Federal crime.

All such information is to be supplied in writing to the Justice Department and other Federal agencies either upon the initiation of the Commissioner or upon the written request of such agencies. The written request would specify the name of the taxpayer, the kind of tax involved, the taxable period involved, and the reasons why inspection is desired.

Once the Justice Department or any Federal agency has received a return (or parts thereof) or return information pursuant to the court order procedure, further disclosure in an administrative hearing or trial relating to the violation of a nontax criminal law would not be allowed unless there is a showing to the presiding hearing officer or judge that the return (or parts thereof) or return information is probative of a matter in issue relevant in establishing the commission of the crime or the guilt of a party. Thus, a return (or parts thereof) or return information would not be admissible for purposes of "collateral impeachment", i.e., discrediting a witness on matters not bearing upon the question of the commission of the crime or the guilt of a party.

As with the initial court order procedure, the Secretary would have the authority to withhold return information from the subsequent criminal trial or hearing upon his determination that the disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation. This authority would apply to return information received under the initial court order procedure and to return information from sources other than the taxpayer furnished by the IRS to the agency. The Secretary would notify the Attorney General or the head of the agency (or their delegates) of the exercise of this authority.

Admission of the return in this proceeding would not, of itself, constitute reversible error in the event of an appeal of the criminal trial court's decision in the nontax criminal case. Thus, while the admission of the return or return information in the proceeding would not constitute reversible error because it was admitted into evidence in violation of this provision, it may nevertheless constitute reversible error on other grounds.

By this Act, the Congress does not intend to limit the right of an agency (or other party) to obtain returns or return information directly from the taxpayer through the applicable discovery procedures.

f. Nontax Civil Matters—Justice Department and Other Federal Agencies

Prior law

Under the regulations, a U.S. Attorney or an attorney of the Justice Department could obtain tax information in nontax civil cases in the same manner and to the same extent as in nontax criminal cases.

The Justice Department used tax returns in suits brought against the Government seeking money damages for injury or wrongful death.

The tax information was used in these cases to verify the claims of loss of income, and also to determine, through claimed medical expense deductions, whether the plaintiff had suffered other injuries before or after the accident in question.

Tax information was also used in suits concerning the renegotiation of Government contracts, where the Renegotiation Board had made a determination that excess profits were earned on renegotiable contracts. Here, tax information was used to verify the income earned on, and the costs related to, the contracts in question.

Nontax civil cases also involve affirmative money claims, including civil fraud claims, by the Government against various private parties. In these cases, tax information was used to determine whether the defendant was financially able to pay the demand contemplated by the Government.

Tax returns were also requested after the Government had obtained a judgment against a party in order to verify statements made by the judgment debtor as to his financial ability to make payment of the debt involved.

Tax information was also made available to each executive department and other establishments of the Federal Government in connection with matters officially before them. Information obtained could be used as evidence in proceedings conducted by or before any Federal agency or proceedings to which the United States was a party.

Under the regulations, tax information could be inspected for nontax administration purposes by Treasury employees (who were not in the IRS) on the written request of the head of the appropriate bureau or office. Also, Customs, Secret Service, and other Treasury enforcement agents could obtain limited tax information on their own request, without the request of the head of their office.

Reasons for change

The current use by the Justice Department and other Federal agencies in the nontax civil cases described above were not warranted in light of the invasions of privacy involved and the fact of the alternative sources of information available to the Justice Department and other agencies in these situations. However, in one limited instance, the Congress decided that disclosure of returns and return information would be made to the Justice Department in those cases involving renegotiation of contracts where the Justice Department, in defending the United States in such cases, would use such returns and return information to verify the income earned on the contracts in question.

Explanation of provision

Under the Act, disclosure of returns and return information could be made to the Justice Department in those instances where it was defending the United States in a suit involving a renegotiation of contracts case previously determined by the Renegotiation Board.

The Act would not permit disclosure to Treasury personnel (other than employees of the IRS) of returns or return information for purposes other than tax administration or statistical use.

By this Act, the Congress did not intend to limit the right of an agency (or other party) to obtain returns or return information directly from the taxpayer through the applicable discovery procedures.

g. Statistical Use

Prior law

Under prior law, several agencies obtained information from tax returns for statistical purposes. Under regulations allowing general inspection of tax information, the Department of Commerce (Census Bureau and Bureau of Economic Analysis) was authorized to use information from tax returns for statistical purposes (Reg. § 301.6103 (a)–104). The Federal Trade Commission (Reg. § 301.6103(a)–106) and the Securities and Exchange Commission (Reg. § 301.6103(a)–102) also were authorized to use information for statistical purposes.

Census Bureau.—The most extensive user of tax information for statistical purposes has been the Census Bureau, within the Department of Commerce.[4] In most cases the Census Bureau does not obtain the full tax returns. The Bureau uses information from tax returns to assist in preparing the Economic Indicators, the Survey of Minority-owned Business Enterprises, and the Survey of County Business Patterns. The Economic Census (conducted every five years) is used for the Index of Industrial Production (of the Federal Reserve Board), the Index of Wholesale Prices (of the Bureau of Labor Statistics), and the Gross National Product accounts. The Current Economic Indicators include information on retail sales, manufacturers' shipments, orders and inventories, investment, and are used for the Index of Industrial Production (Federal Reserve Board). These statistics are used as a basis for national economic policy, for distributing funds by agencies, by State and local governments in determining their programs, and by private business in forecasting, marketing, investment, etc.

In general, these statistics are not based on data from tax returns. Instead, information from tax returns is used by the Census Bureau to prepare lists of persons to be surveyed by the Bureau, to tabulate statistical links between data reported by the IRS and the Census Bureau, to excuse smaller firms from filing reports (by using data from tax returns instead), and to weed out firms that do not need to report.

The Census Bureau has made an analysis of the effect of not allowing it to use tax data. Generally, the Bureau has stated that the effect of entirely prohibiting it from having access to information from tax returns would be to increase significantly the costs of collecting data and to decrease significantly the quality of the statistics developed.

The Census Bureau also uses "relatively small samples of individual tax records," on a case-by-case basis, to compare income reported in tax returns with income reported in the census. Similar evaluation studies are used by the Bureau in connection with surveys such as the Current Population Survey.

Information from tax returns is also used by the Bureau in determining amounts to be allocated under revenue sharing; this use was specifically contemplated by the Congress in establishing the revenue sharing program. (See *General Explanation of the State and Local*

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[4] For example, in 1975, the following income tax return records were transferred to the Census Bureau:

1. 8,400,000 Business Master File Entity Change Records showing employer identification number (EIN), name, address, and zip code.
2. 21,200,000 Forms 941 showing EIN, total compensation, FICA wages, taxable tips, master file account, tax period, and address change.

Fiscal Assistance Act, H.R. 14370, 92nd Congress, Public Law 92–512, page 39 (Feb. 12, 1973).)

Bureau of Economic Analysis.—The Bureau of Economic Analysis (BEA) prepares the National Income Accounts, including the National Income and Product Accounts focusing on GNP, and the Balance of Payments Accounts. BEA has stated that a major input into GNP is the IRS published Statistics of Income series. However, BEA has also stated that it needs access to a sample of large corporation's tax returns to prepare "industry extrapolators," and to be able to distinguish changes in the IRS Statistics of Income series that occur on account of shifts in economic development from changes that occur on account of shifts in tax reporting.

BEA obtains tax information from returns of large corporations. It does not obtain tax information from returns of individuals. Generally, BEA employees examine IRS transcript cards that summarize information from 500 to 1,000 returns of the largest corporations. (In calendar year 1974, BEA obtained 300 "transcript-edit sheets" of corporate returns.) BEA employees copy data from these cards and also inspect 20 to 100 tax returns over the course of a year.

Federal Trade Commission.—The Federal Trade Commission obtains tax information for use in the Industrial and Financial Reports Program and the Quarterly Financial Report series.[5] For the most part, the FTC does not need detailed financial information from the IRS. It does not use information about individuals. The FTC uses the information it receives to develop a sample of corporations which it then surveys. To develop this sample, the FTC needs the following information: name, address, EIN, industry code, sample code, and gross assets indicator. The "industry code" tells what the principal industrial activity of the corporation is. The "sample code" tells the sampling process used by the IRS with respect to its Statistics of Income (not with respect to audit, etc.) and does not appear to be tax information. A gross assets indicator would tell, e.g., whether the corporation has gross assets of over $10 million, $5–$10 million, $3–$5 million, $1–$3 million, or less than $1 million. Other information, such as the accounting period and the consolidated return indicator, are helpful to the FTC in developing more accurate statistics but are not basic to its statistical process.

Securities and Exchange Commission.—The SEC has not obtained tax information for statistical purposes for several years, since the functions for which the SEC required this information were moved to the Federal Trade Commission.

Reasons for change

Congress recognizes the importance to other Federal agencies to be allowed the use of returns and return information in connection with certain of their statistical and research functions. Since there does not appear to be any real likelihood that the use of returns and

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[5] The Federal Trade Commission obtained the following tax information in 1974:

1. 58,729 specially prepared abstract sheets for corporation returns.
2. 43,000 Forms 1120, etc., including name, address, EIN, date incorporated, gross receipts, taxable income, total assets, industry code, accounting period, and name, address and EIN of consolidated subsidiaries.
3. 31,000 abstracts of corporate tax returns showing name, address, zip code, EIN, date incorporated, gross receipts, taxable income, total assets, industry code, accounting period, and name, address, and EIN of consolidated subsidiaries.

return information by these agencies would, under the procedures and safeguards provided for in the Act, result in an abuse of the privacy or other rights of the taxpayers whose returns and return information are used, Congress decided that the use of returns and return information should be available for statistical use by certain agencies other than the IRS.

Explanation of provision

Under the Act, the Census Bureau, the Bureau of Economic Analysis, and the Federal Trade Commission can obtain tax returns and limited tax information solely for statistical and research purposes authorized by law, but only such tax information as is necessary to carry out those statistical and research activities. The Federal Trade Commission and the Bureau of Economic Analysis will only be entitled to receive corporate tax information.

In addition, returns and return information will be open to inspection by, or disclosure to, officers and employees of the Department of the Treasury (other than officers and employees of the Internal Revenue Service) whose official duties require such inspection or disclosure for purposes of preparing economic or financial forecasts, projections, analyses, and statistical studies and conducting related activities. Inspection or disclosure is permitted only upon a written request setting forth the specific reason or reasons why such inspection or disclosure is desired and signed by the head of the bureau or office of the Department of the Treasury requesting the inspection or disclosure.

Treasury regulations are to specify the limited types of tax information (e.g., name, address, social security number, gross receipts, etc.) which may be supplied to each agency under this provision. The publication of any statistical study which would identify any particular taxpayer is prohibited.

h. Other Agencies—Inspection on a General Basis

Prior law

Under the regulations, several agencies could generally inspect tax information for qualified purposes without the head of the agency having to write a specific request to the IRS identifying the taxpayer and the reason for the desired inspection. Inspection of tax information on a general basis was made most often by the Department of Health, Education, and Welfare, the Renegotiation Board and the Federal Trade Commission.

The Department of Health, Education, and Welfare could inspect individual tax returns as required to administer Title II of the Social Security Act (old-age, survivor, etc., benefits). Inspection was authorized on the written application of any authorized officer or employee of the department. (Reg. § 301.6103(a)–100.) In calendar year 1974, the Social Security Administration was furnished 6,633 returns for administering Title II of the Social Security Act. In most cases tax data were requested by the Social Security Administration to obtain evidence of earnings so that an individual's entitlement to monthly benefits could be properly determined. This information could be used to the benefit of the individual or to the benefit of the government with respect to determining Social Security benefits. In addition, 27,-000,000 employment tax schedules were furnished annually to the

Social Security Administration for purposes of administering the Social Security Act.

The Renegotiation Board was authorized to obtain income tax information "in the interest of the internal management of the government." The Renegotiation Board is charged with administering the laws to renegotiate contracts with government contractors to eliminate excess profits. (Reg. § 301.6103(a)-105.) In 1974 the Renegotiation Board was furnished 1,803 transcripts (i.e., abstracts of corporation tax returns), including information on the taxpayer's gross receipts, taxable income, accounting period, identification of related companies, etc. The Renegotiation Board used tax information to help determine whether excessive profits have been derived from negotiable contracts and related subcontracts made with the United States.

The Federal Trade Commission was authorized to obtain income tax information of corporations "as an aid in executing the powers conferred upon such Commission by the Federal Trade Commission Act." Any authorized officer or employee of the FTC could make inspection. (Reg. § 301.6103(a)-106.)

Reasons for change

Congress decided that in many situations the current use of returns and return information on a general basis is not warranted. Congress decided to limit strictly the types of returns and return information which will be made available to other agencies on a general basis for purposes other than tax administration or statistical use and the situations in which they will be made available. Generally, these are situations where the return information is directly related to programs administered by the agency in question.

Explanation of provisions

The Act permits limited disclosures on a general basis (upon written request) to the Social Security Administration, the Railroad Retirement Board, the Department of Labor, the Pension Benefit Guaranty Corporation and the Renegotiation Board for purposes other than tax administration. Under this provision, disclosure will be made to officers and employees of the receiving agency who are duly authorized and specifically designated in writing by the receiving agency to receive the returns or return information. Any authorized research or statistical project conducted by these agencies which involves the use of return information will not be subject to disclosure by them in a form which can be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.

The Act permits the Social Security Administration to obtain returns and return information concerning employment taxes for purposes of the administration of the civil and criminal provisions of the Social Security Act. Also, the Railroad Retirement Board can obtain returns and return information for purposes of the administration of the civil and criminal provisions of the Railroad Retirement Act. The Internal Revenue Service is also authorized to furnish certain returns and limited return information to designated officers and employees of the Department of Labor and the Pension Benefit Guaranty Corporation for purposes of the administration of the civil and criminal provisions of the pension reform act (the Employees Retirement Income Security Act of 1974). In addition, as provided in the pension reform act, copies of annual registration statements of employee benefit plans and related information concerning vested benefits of employees may be furnished to the Social Security Administration.

Under the Act, the Renegotiation Board can, upon the written request of its chairman, continue to receive returns and return information with respect to the income tax for purposes of administering the Renegotiation Act. The returns and return information so provided will be open to duly authorized and specifically designated officers and employees of the Board personally and directly engaged in, and solely for their use in, verifying or analyzing financial information required by the Renegotiation Act to be filed with, or otherwise disclosed to the Board, or to the extent necessary to implement the provision in the Code relating to the mitigation of the effect of the renegotiation of government contracts (sections 1481 and 1482). The Renegotiation Board, through its chairman, will be allowed to disclose these returns and return information to the Justice Department upon a referral of one of its cases to this agency for further legal action.

i. State and Local Governments

Prior law

On the written request of the State governor, individuals' and organizations' tax returns could be inspected by State tax officials for purposes of administering the State's tax laws. At the governor's written request, tax information could also be obtained for local governments to be used in administering their tax laws. (Sec. 6103(b).) Income tax information was not furnished directly by the IRS to local governments. Instead, State tax officials furnished such information to local governments where the IRS had approved such action at the request of the governor.

Under the regulations, with the permission of the Commissioner and for purposes of State tax administration, a State was allowed to inspect on a general basis all income, estate, and gift tax returns filed in the district in which the State is located. The same was true for other types of returns such as estate tax and gift tax returns. Additionally, the specifically identified returns of taxpayers who filed within the relevant district, and of taxpayers who filed in districts not including the State in question, could be inspected on a case-by-case basis on the written request of the State governor.

On request, the Commissioner could allow each State to inspect on a general basis all tax returns filed by residents of the State. The ability to inspect returns under this procedure applied to the physical inspection of the documents in question.

The States could also enter into tax coordination agreements with the IRS with respect to inspection of tax information. These agreements generally provided for cooperation between the IRS and the States in tax administration, for an exchange of tax information, for assistance in locating delinquent taxpayers (and their property), and for cooperative audits; the agreements also provided for preserving the confidentiality of tax information.[6]

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[6] A State was not precluded from inspecting tax information if it had not entered into an agreement.

By far the largest IRS/State information exchange program, in terms of amounts of information transferred, was the furnishing of Federal tax information on magnetic tape. In 1975, 48 States (plus the District of Columbia, American Samoa, Guam, and Puerto Rico) participated in this program. Under the 1975 Individual Master File (IMF) program, information on nearly 66 million taxpayers was provided to the States. (This covered approximately 80 percent of individual taxpayer records.) IMF tax data available to the States included name, address, social security number, filing status, tax period, exemptions claimed, wages and salaries, adjusted gross income, interest income, taxable dividends, total tax, and audit adjustment amount. Under the tape exchange programs, the States agreed to conduct a joint review with the IRS of safeguards of tax information.

A Business Master File (BMF) program was also available to the States to aid them in establishing their own business master files. Information from the Exempt Organization Master File was also available to the States, as was gift tax data.

Under the cooperative audit program, copies of examination reports were furnished the States. In 1974, nearly 700,000 abstracts of these reports were furnished the States. Also, the IRS furnishes the States information on returns that appear to have good audit potential but will not be audited by IRS because of manpower restrictions. In 1974, information was furnished on more than 70,000 returns under this program.

Reasons for change

It has been suggested that tax information that is supplied to tax officials at the State and local levels may not always be subject to appropriate safeguards on confidentiality. Also, it has been suggested that political considerations may produce unwarranted interest by State and local governments in tax information for nontax purposes.

IRS studies have indicated that in several situations, State authorities have allowed other States (or local governments) to inspect Federal tax information, have not maintained adequate records of inspection of Federal tax information, and have inadequate procedures to instruct employees with respect to Federal tax return confidentiality. However, it is understood that when these problems have been brought to the attention of the State authorities involved, remedial action has been taken.

Congress feels that it is important that the States continue to have access to Federal tax information for tax administration purposes. With Federal tax information, the States are able to determine if there are discrepancies between the State and Federal returns in, *e.g.*, reported income. Also, many States have only a few, if any, of their own tax auditors and rely largely (or entirely) on Federal tax information in enforcing their own tax laws.

Explanation of provision

The Act authorizes, upon the written request of the principal tax official of the State (other than the governor), the disclosure of income, estate, gift, social security (FICA), unemployment (FUTA), self-employment (SECA), withholding, alcohol, tobacco, and highway use tax returns and return information solely for the purpose of, and only to the extent necessary in, the administration of the State's tax laws. It is intended that regulations be issued specifying the manner in which and the conditions under which returns and return information would be disclosed to State tax officials. The Act also authorizes disclosures of this Federal tax data to the legal representative of the State tax agency for purposes of administering State tax laws. Congress intended that the statutory relevancy tests applicable to access to Federal tax data by the Justice Department in a Federal tax investigation or in preparing for Federal tax litigation be applicable to disclosures to the State tax agency's legal representative.

The returns and return information will only be open to inspection by or disclosure to those duly authorized representatives of a State agency, body, or commission charged with the responsibility of the administration of State tax laws who are designated in the written request as the individuals who are to inspect or receive the returns or return information on behalf of the agency, body, or commission. The returns and return information so disclosed will not be available to the State governor or any other nontax personnel. The prohibition against disclosure of Federal returns and return information to the State governor will apply even in those situations where the governor, under State law, is considered to be the principal tax official of the State.

The general authority provided to the IRS by the Act (see the discussion below of Procedures and Safeguards) to require recipients of Federal returns and return information to maintain adequate procedures for safeguarding the Federal returns and return information also applies with respect to the States. Thus, the IRS is authorized to take such steps as it considers necessary, including the withholding of further Federal returns and return information (subject to the administrative appeal procedure; see Safeguards below), in the event the State did not maintain adequate safeguards for, or in the event of unauthorized disclosures of, Federal returns and return information. It is intended that this authority should be broadly construed to cover disclosures of, and the failure to maintain adequate safeguards for, State returns and return information or other information, to the extent disclosures of such information might indirectly jeopardize the confidentiality of the Federal return or return information furnished to the States.

No disclosure may be made to any State that requires taxpayers to attach to, or include in, State tax returns a copy of any portion of the Federal return (or any information reflected on the Federal return) unless the State adopts provisions of law by December 31, 1978, protecting the confidentiality of the attached copies of the Federal returns and the included return information. Although the copies of the Federal returns or the return information required by a State or local government to be attached to, or included in, the State or local return do not constitute Federal "returns or return information" subject to the Federal confidentiality rules, the policy underlying this requirement is that the attached copy of the return and the included information should be treated by State and local governments as confidential rather than effectively as public information. However, it is not intended that States be required to enact confidentiality statutes which are copies of the Federal statutes. Thus, State tax authorities can disclose State returns and return information, including any portion of the Federal return (or information reflected on the Federal return) which the State requires the taxpayer to attach to, or to include in, his State tax return, to any State or local officers or employees whose official duties or responsibilities require access to such State return or return information pursuant to specific laws of that State.

In order to protect the confidentiality of returns which the States receive from the IRS under the present exchange programs, the returns are, in most States, processed on computers used solely by the State tax authorities. In certain States, however, the requirements of the tax authorities are not sufficient to justify a separate computer, and, accordingly, the tax authorities have the Federal tax returns processed on central computers shared by several State agencies which are operated by State employees who are not in the tax department. In such situations, the IRS requires that tax department personnel be present at all times when the Federal tax returns are being processed. The Act permits time-sharing with other State agencies so to the extent authorized and under the conditions specified in Treasury regulations.

The Act does not permit the disclosure of Federal returns and return information (other than information with respect to tax return preparers as described below) to local tax authorities, either directly by the IRS or indirectly by the State tax authorities. However, Congress does not intend by this decision to limit the disclosure by State tax officials to local tax authorities of State tax returns and return information. For this purpose, State return information which may be disclosed to local tax authorities includes information resulting from tax audits and investigations conducted by State tax authorities, even where that information is based on or is substantially similar to Federal return information supplied or made available to the State tax authorities. It is not, of course, permissible for State tax officials merely to transcribe Federal return information, designate it as State tax information, and furnish it to local tax authorities as information resulting from a State tax audit investigation. Moreover, under the general authority of the IRS to require States to maintain adequate procedures for safeguarding Federal returns and return information, the IRS may take such steps as it considers necessary, including withholding Federal returns and return information from the States, in any situation where it finds that disclosures of, or the failure to maintain adequate safegards for, such State return information furnished to local tax authorities may have the result of jeopardizing the confidentiality of the Federal return information.

In those States electing piggybacking under section 6361 of the Code, Congress intends State tax administration to include the activities of State tax authorities in conducting supplemental audits, however limited in scope and authority. Thus, to the extent that State tax authorities in States electing piggybacking can, consistent with section 6361, conduct supplemental audits directed towards increasing State tax revenues (whether by referring the information gathered in the audits to the IRS for final action, by auditing under the supervision of the IRS, or through some other approach), disclosure of Federal returns and return information to those State tax authorities generally will be required under section 6103(d).

In addition, taxpayer identity information (name, mailing address, and taxpayer identifying number) of any tax return preparer (as defined in section 7701(a)(36)) may be disclosed to any State or local agency, body, or commission charged with licensing, registration, or regulation of tax return preparers. The fact of any penalty imposed on a tax return preparer under sections 6694, 6695, or 7216 for the unlawful disclosure or use of tax information may also be disclosed.

As in the case of returns and return information disclosed to other agencies, the unauthorized disclosure by State tax officials of Federal returns or return information is a violation of Federal law subject to civil liability and criminal penalties.

Return information will not be disclosed to a State in the event the Secretary determined that the disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation.

j. Taxpayers With a Material Interest

Prior law

Under the regulations, income tax returns were open to the filing taxpayer, trust beneficiaries, partners, heirs of the decedent, etc. "Return information", as opposed to the tax returns themselves, was only available to the taxpayer, etc., at the discretion of the IRS.

Also, the statute specifically authorized the inspection of a corporation's income tax returns by a holder of 1 percent or more of the corporation's stock. (Sec. 6103(c).)

Reasons for change

Congress decided that persons with a material interest should continue to have the right to inspect returns and, where appropriate, return information to the same extent as provided under prior regulations.

Explanation of provision

Under the Act, disclosure can be made, upon written request, to the filing taxpayer, either spouse who filed a joint return, the partners of a partnership, the shareholders of subchapter S corporations, the administrator, executor or trustee of an estate (and the heirs of the estate with a material interest that may be affected by the information), the trustee of a trust (and beneficiaries with a material interest), persons authorized to act on behalf of a dissolved corporation, a receiver or trustee in bankruptcy, and the committee, trustee or guardian of an incompetent taxpayer. The provision in prior law authorizing a one-percent shareholder to inspect a corporation's return is also retained. Return information (in contrast to "returns") may be disclosed to persons with a material interest only to the extent the IRS determines this would not adversely affect the administration of the tax laws.

k. Miscellaneous Disclosures

Prior law

Under prior law, several provisions of the regulations allowed disclosure of tax information for miscellaneous administrative and other purposes. For example, accepted offers in compromise (under sec. 7122) were open to inspection. Internal revenue officers could disclose limited information to verify a deduction, etc. Additionally, in a number of cases, tax information could be disclosed at the discretion of the Commissioner, as the statute was wholly silent with respect to certain types of returns. For example, FICA tax returns were within this category.

In other cases, the statute specifically required public disclosure of certain types of returns. Under the Code, applications for exempt status by organizations and applications for qualification of pension, etc., plans were generally open to public inspection. (Sec. 6104(a).) Also, the annual reports of private foundations were open to public inspection. (Sec. 6104(d).) Returns with respect to the taxes on gasoline and lubricating oils were open to inspection by State officials. (Sec. 4102.) Under certain circumstances, the amount of an outstanding tax lien could be disclosed. (Sec. 6323(f).)

Upon inquiry, the IRS was required to disclose whether any person had filed an income tax return for the year in question. (Sec. 6103(f).) Inquiries under section 6103(f) were made by, among others, news media and commercial concerns.

Additionally, the IRS sometimes was asked to provide information concerning a taxpayer's address. Address information would be provided to State or local officials for tax administration purposes, to State or local enforcement officials if furnishing the information would aid in Federal special enforcement programs (*e.g.*, narcotics programs), to Federal agencies in general to assist in administering their responsibilities and to "educational lending institutions" to locate delinquent borrowers under Federal loan guarantees. Address information would not, however, be provided to commercial concerns. Also, address information was provided to the Federal Parent Locator Service regarding "absent parents" under Public Law 93–647 (section 453 of the Social Security Act). Address information also could be provided individuals in emergency situations.

Under prior law, the GAO did not have independent authority to inspect tax returns. It did have access to tax returns when it audited IRS operations as the agent of the Joint Committee on Taxation.

Reasons for change

Congress decided that it was necessary to allow the disclosure of returns and return information in certain miscellaneous situations. In most of these situations, disclosure was permitted under prior law. In each situation, Congress decided either that the returns or return information should be public as a matter of policy, or that the reasons for the limited disclosures involved outweighed any possible invasion of the taxpayer's privacy which might result from the disclosure.

Explanation of provision

Returns will continue to be open to public inspection in those situations where public disclosure was provided for in prior law under section 6104. This includes applications for exempt status by organizations, applications for qualification of pension, etc. plans, the annual reports of private foundations, and returns filed with respect to the excise taxes imposed on private foundations and pension plans (under chapters 42 and 43).

Return information may be disclosed to members of the general public to the extent necessary to permit inspection of any accepted offer-in-compromise under section 7122. If a notice of lien has been filed (pursuant to section 6323(f)), the amount of the outstanding obligation secured by the lien is authorized to be disclosed to any person who furnishes satisfactory written evidence that he has a right in the property subject to such lien or intends to obtain a right in such property. Disclosures to foreign governments is authorized to the extent provided for in tax treaties.

The Act authorizes the GAO to inspect returns and return information to the extent necessary in conducting an audit of the IRS or the Bureau of Alcohol, Tobacco and Firearms required by section 117 of the Budget and Accounting Procedures Act of 1950. It is intended that the GAO examine returns and individual tax transactions only for the purpose of, and to the extent necessary to serve as a reasonable basis for, evaluating the effectiveness, efficiency and economy of IRS operations and activities. It is not intended that the GAO would superimpose its judgment upon that of the IRS in specific tax cases. GAO is to notify the Joint Committee on Taxation in writing of the subject matter of the planned audit and any plans for inspection of tax returns. GAO can proceed with its planned audit unless the Joint Committee, by a two-thirds vote of its members, vetoes the GAO audit plan within 30 days of receiving written notice of the proposed audit from GAO.

The Act also authorizes the GAO to review and evaluate the compliance by the Federal and State agencies which have received returns and return information from the IRS with the requirements regarding the use and safeguarding of the returns and return information.

Alcohol, tobacco, wagering and firearms tax information may be disclosed pursuant to Treasury regulations to Federal agencies that require this information in their official duties.

The Act modifies the rules for the disclosure of return information to the Federal, State and local child support enforcement offices by providing for disclosure of certain information from IRS master files. Disclosure of other return information is permitted only to the extent that it cannot be reasonably obtained from another source. Congress did not intend, however, that the child support enforcement agency be authorized to disclose Federal return information to third parties or in litigation relating to establishing or collecting child support obligations.

The Act also authorizes the IRS to disclose to other Federal agencies the mailing addresses of taxpayers from whom the agencies are attempting to collect a claim under the Federal Claims Collection Act.

The Act authorizes the IRS, upon written request, to disclose returns and return information to the Privacy Protection Study Commission, or to such members, officers, or employees of the commission as may be named in the written request, to the extent, and for such purposes, as provided by section 5 of the Privacy Act of 1974.

The IRS is authorized to disclose, to the extent necessary for purposes of tax administration, returns and return information to any person with respect to his performance of services in connection with the processing, storage, transmission, or reproduction of returns and return information or in connection with the programming, maintenance, repair, testing, and procurement of equipment.

Disclosures to the press and other media are permitted for purposes of notifying a person entitled to a Federal tax refund when, after reasonable time and effort, the IRS is unable to locate the person.

The IRS is authorized to disclose relevant returns and return information to an employee (or former employee) of the IRS and to his attorney in an adverse proceeding against the employee. This need for limited disclosures arises, for example, in proceedings brought against the employee for harassment of a taxpayer.

Disclosures, as necessary, are also permitted to persons (and their legal representatives) whose rights to practice before the IRS may be affected by an administrative action or proceeding.

Under the Act, the Secretary may, in his discretion but only following approval by the Joint Committee on Taxation, disclose, as he considers advisable for purposes of tax administration, such return information or other information with respect to any specified taxpayer to the extent necessary to correct a misstatement of fact published or disclosed with respect to such taxpayer's return or dealing with the IRS.

IRS officials and employees are permitted, if no reasonable alternative exists, to make limited disclosures of return information in connection with an audit or investigation to the extent necessary in arriving at a correct determination of tax, liability for tax, or the amount to be collected, or otherwise in the enforcement of any provision in the Code. In certain instances, it may be necessary for IRS personnel, in obtaining information with respect to a taxpayer from a third party, to disclose the fact that the request for information is in connection with an audit or other tax investigation of the taxpayer. In rare and extraordinary cases, it may also be necessary for IRS personnel in obtaining information from a third party to disclose additional return information, such as the manner in which the taxpayer treated on his return a transaction with the third party. Disclosures under this provision are to be made only in situations and under conditions specified in the regulations. This provision is not intended to permit disclosure which would not have been permitted under prior law.

Certain miscellaneous disclosures provided for in prior law would no longer be authorized. For instance, the provision in prior law authorizing the IRS to disclose, upon inquiry, whether a person has filed an income tax return for a particular year, is repealed.

l. Procedures and Records Concerning Disclosure

Prior law

Several different offices of the IRS had responsibility for approving disclosure of tax information to particular agencies. For example, the Disclosure Staff (National Office) dealt with case-by-case requests for tax returns by other Federal agencies while the Statistics Division dealt with the disclosure of information to Federal agencies (largely on magnetic tape) to be used for statistical purposes. Additionally, the Planning and Research Division dealt with disclosure of information on magnetic tape to the States while the Disclosure Staff dealt with case-by-case disclosure to the States.

While these offices negotiated and approved disclosures of tax information, the actual transfer of the information generally took place in other offices, such as the Service Centers, District Office, Computer Center, etc. In addition, District Directors and Service Center Directors were authorized to approve applications for certain types of disclosure, such as disclosure to persons with a material interest in the return, or disclosure of returns of the taxpayer (in tax cases) to U.S. attorneys.

Although the IRS maintained records concerning disclosure, it is understood that the type of records maintained were not standardized as between, *e.g.*, Service Centers, and that the IRS did not maintain a complete inventory of records so, for example, it could not determine what had been disclosed and what had been returned or destroyed.

Under the Privacy Act of 1974 (P.L. 93–579), each Federal agency is to account for disclosures to other agencies, noting the date, nature, and purpose of each disclosure and the name and address of the agency to which disclosure is made. This rule does not apply to disclosures by State agencies. The accounting is designed to enable the agency to inform the individual concerned of disclosures made with respect to him.

Reasons for change

Recently, there have been reports that tax information was improperly transferred outside the IRS. There does not presently appear to be a standardized system of accounting for disclosure which would permit the IRS to determine what information has been transferred, for what purposes, what use has been made of it, and whether it has been destroyed, returned, etc., after it has been used. Also, studies indicate that in several situations, inadequate records have been maintained of transfer of tax information to the various Federal agencies and to State authorities and that in certain instances IRS procedures have not been properly followed.

Explanation of provision

In those cases in which disclosure or inspection of returns and return information is permitted by the Act, it is permitted only at the times, in the manner, and at the places prescribed by the IRS.

It is intended that, to the extent practical, all disclosures of return information be made in documentary form in order to protect the privacy of the taxpayer and to protect the IRS personnel making the disclosure from subsequent charges that information was improperly disclosed. Disclosure in documentary form would serve to preserve an exact record of the information disclosed so as to make it possible to determine, should the question arise, whether an unauthorized disclosure of information had been made. Congress recognizes, however, that it may not be possible or practical in every instance for return information to be disclosed in documentary form (*e.g.*, discussions between IRS personnel and Justice Department attorneys with respect to a pending tax case being handled by the Justice Department).

The Act requires the IRS to maintain a standardized system of permanent records on the use and disclosure of returns and return information. This would include copies of all requests for inspection or disclosure of returns or return information and a record of all inspections and disclosures of returns and return information. In the case of the inspection or disclosure of documentary information, such as a return, which the IRS retains in some form in its records either permanently or for a substantial period (*e.g.*, 10 years), the record of the inspection or disclosure would include an identification of the document, or part thereof, disclosed or inspected. In the case of inspections or disclosures of documents which the IRS would not otherwise retain for a substantial period, the record should contain a copy of the document.

The recordkeeping requirements do not apply in certain situations, including disclosure of returns and return information open to the public generally (accepted offers-in-compromise, the amounts of outstanding tax liens, information returns of exempt organizations, etc.), disclosures to the Treasury or the Justice Department for tax administration and litigation purposes, disclosures to persons with a material interest, disclosures to persons upon the taxpayer's written consent, disclosures to the media of taxpayer identity information and disclosures to contractors who perform processing, storage, transmission, reproduction, programming, maintenance, testing, or procurement of equipment services for the IRS. The Act also makes it clear that the IRS is not required to disclose to taxpayers under the Privacy Act any disclosures made to the persons and agencies with respect to which the recordkeeping requirements do not apply. In addition, the Act makes it clear that the recordkeeping requirements of the Privacy Act cannot be utilized to resolve substantive tax disputes.

The Act requires the IRS to establish one office which would have the responsibility for approving all inspections and disclosures of returns and return information. However, upon approval of that office, disclosure of tax returns may be made by district offices where appropriate and to the extent provided for in regulations. In addition, authority may be delegated to the district offices on a general basis with respect to disclosures or inspections of returns and return information open to the public generally.

In addition to the recordkeeping requirements imposed on the IRS, the Act provides that each Federal and State agency that receives tax information is required, pursuant to Treasury regulations, to maintain a standardized system of permanent records on the use and disclosure of that information. Maintaining such records is a prerequisite to obtaining and continuing to receive tax information.

m. Safeguards

Prior law

Except for the general criminal penalty for unauthorized disclosure, the tax law did not provide rules for safeguarding tax information disclosed by the IRS to other agencies. However, some of the Agreements on Coordination of Tax Administration entered into between the Federal Government and the States included provisions for safeguarding tax information.

The Privacy Act requires that each agency establish appropriate administrative, technical, and physical safeguards to secure records on individuals. This requirement applies to each Federal agency that maintains a "system of records." This provision does not apply to State or local government agencies that receive Federal tax records.

The IRS has no authority under the Privacy Act to audit the safeguards established by other agencies, or to stop disclosure to other agencies that do not properly maintain safeguards.

Reasons for change

Congress decided that, although it is necessary to permit the disclosure of Federal returns and return information to other Federal and State agencies in certain situations for purposes other than the administration of the Federal tax laws, no such disclosure should be made unless the recipient agency complies with a comprehensive system of administrative, technical, and physical safeguards designed to protect the confidentiality of the returns and return information and to make certain that they are not used for purposes other than the purposes for which they were disclosed.

Explanation of provision

The Act provides that no tax information may be furnished by the IRS to another agency (including commissions, States, etc.) unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives. Disclosure of tax information to other agencies is conditioned on the recipient maintaining a secure place for storing the information, restricting access to the information to people whose duty requires access and to people to whom disclosure can be made under the law, providing other safeguards necessary to keeping the information confidential, and returning or destroying the information when the agency is finished with it. The Act specifically authorizes regulations allowing the IRS to carry out these provisions. The IRS is to review, on a regular basis, safeguards established by other agencies.

If there are any unauthorized disclosures by employees of the other agency, disclosure of tax information to that agency may be discontinued until the IRS is satisfied that adequate protective measures have been taken to prevent a repetition of the unauthorized disclosure. In addition, the IRS may terminate disclosure to any agency if the IRS determines that adequate safeguards are not being maintained by the agency in question. In this connection, the Act requires that an administrative procedure be established by regulations under which the States will, under appropriate circumstances, have an opportunity, prior to the cut-off of returns and return information, to contest a preliminary finding by the IRS of inadequate safeguards or unauthorized disclosures, or to establish that steps had been taken which would prevent a repetition of the violation.

The authority of the IRS with respect to safeguarding the confidentiality of returns and return information furnished to other agencies is intended to be sufficiently broad to permit the IRS to take such steps, pursuant to regulations, as are necessary to prevent indirect disclosures of return information. Indirect disclosures might include disclosures by recipient agencies of information received by the agency from sources other than the IRS which is the same or substantially the same as return information furnished to that agency by the IRS, where that disclosure would conflict with the congressional policy expressed by this amendment of protecting the confidentiality of returns and return information.

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n. Reports to Congress

Prior law

Beginning in 1971 the Joint Committee on Taxation received from the IRS a semi-annual report on disclosure of tax information.

Reasons for change

Because the use of returns and return information for purposes other than tax administration resulted in serious abuses of the rights of taxpayers in the past, and because the potential for abuse necessarily exists in any situation in which returns and return information are disclosed by the IRS to other Federal agencies and the States for purposes other than the administration of the Federal tax laws, Congress believes that it must review very closely the use of returns and return information and the extent to which taxpayer privacy is being protected. In order to permit that review, Congress decided to require that the IRS make certain comprehensive annual reports to the Joint Committee as to the use of returns and return information.

Explanation of provision

Within 90 days after the end of each calendar year, the IRS is required to report to the Joint Committee on Taxation on all requests (and the reasons therefor) received for inspection or disclosure of returns or return information. The report is not to include, however, a listing of any requests by the President for returns or return information with respect to current employees of the Executive Branch. The report will be confidential unless a majority of the members of the Joint Committee agree by record vote to disclose all or any portion of the report. The report is to include, as a separate section which will be publicly disclosed in all cases, a listing of all agencies receiving tax return information, the number of cases in which a tax return or tax return information was disclosed to them during the year, and the general purposes for which the requests were made.

Included in the report to the Joint Committee will be a listing of all requests for tax-checks of current employees of the Executive Branch (other than such requests made by the President), and all requests for tax-checks made by the President or the head of a Federal agency with respect to prospective employees. The listing is to set forth the reasons for each request, the taxpayer involved, and the particular returns and return information disclosed. This portion of the report will also be confidential and is not to be disclosed unless the Joint Committee determines that disclosures would be in the national interest.

The IRS is required to report quarterly to the Congressional tax committees on the procedures established for maintaining the confidentiality of tax information disclosed outside the IRS, on the implementation of these procedures, and on any problems that may develop in connection with these procedures.

o. Enforcement

Prior law

Unauthorized disclosure of a Federal income return, or financial information appearing on an income return (the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return), by a Federal or State employee was a misdemeanor punishable by a fine of up to $1,000, or imprisonment of up to one year, or both (together with the costs of prosecution). In addition, Federal officers or employees were to be dismissed from office or discharged from employment. It was also a misdemeanor (punishable in the same manner) for any person to print or publish in any manner not provided by law an income return or financial information appearing therein. (Sec. 7213(a) (1) and (2) of the Code: see also 18 U.S.C. § 1905.)

Shareholders who were permitted under section 6103(c) to examine a corporate return were guilty of a misdemeanor (punishable as above) if they disclosed in any manner not provided by law the amount of any income, etc., shown on the return.

During fiscal years 1973–75, the IRS conducted investigations concerning the possible improper disclosure of confidential information as follows:

	Fiscal year—		
	1973	1974	1975
Investigations conducted	58	103	179
Disciplinary actions	9	23	23
Separations from employment	4	2	5

There have also been criminal prosecutions for illegal disclosure of confidential tax information, as follows:

	Fiscal year—		
	1973	1974	1975
Prosecution referrals	8	8	4
Prosecutions declined	7	5	4
Convictions	1	3	0

Two of the four people convicted were IRS employees and two were private detectives. The two IRS employees were given probation (and one was fined $350). The two private detectives were each fined $250, placed on two-year probation, and jailed for short periods of time (i.e, 24 hours over a period of two days).

Reasons for change

Congress decided that the prior provisions of law designed to enforce the rules against the improper use or disclosure of returns and return information were inadequate. Congress decided that the criminal penalties for an unauthorized disclosure should be increased and that the situations to which they apply should be broadened to cover all situations in which returns and return information are treated as confidential. It was the opinion of Congress that in situations where an unauthorized disclosure is made to a person in exchange for an offer by that person of something of material value, that the person actively soliciting the unauthorized disclosure is at least equally responsible as the person making the disclosure and thus should be subject to the same punishment. Congress also decided that, in order to redress any injury sustained and to aid in the enforcement of the confidentiality rules, a civil action for damages should be provided to any person injured by a willful or negligent disclosure in violation of the Act.

Explanation of provision

Under the Act, a criminal violation of the disclosure rules is a felony rather than a misdemeanor. The criminal penalties for an unauthorized disclosure of a return or return information are increased to a fine of up to $5,000 (instead of $1,000) and up to five years imprisonment (instead of one year), or both. Under prior law, criminal prosecutions for unauthorized disclosures were undertaken only where the individual made the disclosure knowing it to be unauthorized. Congress intended for this prosecutorial standard to be continued, particularly in view of the increase of the penalty for unauthorized disclosure from a misdemeanor to a felony.

The unauthorized disclosures with respect to which the criminal penalties apply are expanded beyond those subject to criminal penalties under prior law. The penalties apply to any unauthorized disclosure of any return or return information; they do not, as under prior law, apply solely to unauthorized disclosures of income returns and financial information appearing on income returns. As under prior law, the criminal penalties apply to unlawful disclosures by any Federal officers or employee, by any officer, employee, or agent or any State or political subdivision, or by any one-percent shareholder allowed to inspect the returns of a corporation. In addition, the criminal sanctions apply to former Federal and State officers and to officers and employees of contractors having access to returns and return information in connection with the processing, storage, transmission, and reproduction of such returns and return information, and the programming, maintenance, etc., of equipment. The criminal penalties also apply to any person who prints or publishes any return or return information which he knows was disclosed to him in violation of the law (as contrasted with prior law under which the criminal penalties only applied to the unauthorized printing or publishing of income returns or certain financial information appearing thereon).

The Act also makes it a felony, subject to the same penalties, for any person willfully to receive returns or return information as the result of a solicitation of the returns or return information. The criminal penalties only apply if the person making the solicitation knows that the disclosure to him of the returns or return information is unlawful. For this purpose, a solicitation means an offer to exchange an item of material value in return for the unauthorized disclosure of the returns or return information. Thus, the criminal penalties do not apply to the receipt of returns or return information as the result of a request if the person making the request does not offer to exchange an item of material value for the disclosure, even where that person knows that the disclosure to him is in violation of the law.

Congress also decided to establish a civil remedy for any taxpayer damaged by an unlawful disclosure of returns or return information. The cause of action extends to any disclosure of return or return information which is made in violation of section 6103. Under the Act, any person who willfully or negligently discloses returns or return information in violation of the law is liable to any taxpayer for actual damages sustained plus court costs. Punitive damages are also authorized in situations where the unlawful disclosure is willful or is the result of gross negligence. Because of the difficulty in establishing in monetary terms the damages sustained by a taxpayer as the result of the invasion of his privacy caused by an unlawful disclosure of his returns or return information, the Act provides that these damages are, in no event, to be less than liquidated damages of $1,000 for each disclosure. Congress does not intend that a disclosure of returns or return information made pursuant to a good faith, but erroneous, interpretation of the confidentiality rules would constitute an actionable disclosure. Instead, disclosures which would give rise to civil liability are limited to those situations where the unauthorized disclosure results from a willful or negligent failure of the person to comply with the procedures and safeguards provided for in the Act and in regulations interpreting the Act.

Effective date

This provision applies to disclosures of tax returns and tax return information made after December 31, 1976. With respect to disclosures by the IRS of returns and return information to Federal agencies under prior law, Congress intended that such recipient Federal agencies be permitted, with one exception, to use such returns and return information for purposes specifically authorized by prior law. The exception to this rule is the use of the returns and return information in administrative or judicial proceedings. In such cases, the statutory limitations on such use imposed by the Act are to be applicable on and after January 1, 1977.

3. Income Tax Return Preparers (sec. 1203 of the Act and secs. 6060, 6103, 6107, 6109, 6503–6504, 6511, 6694–96, 7407–08, 7427–28, and 7701 of the Code)

Prior law

The Internal Revenue Code formerly contained few provisions which related to the conduct of persons who prepare the tax returns of other persons for a fee. The tax return forms generally required that any person preparing a return for another person sign the return, but the law provided no penalty in cases of failure to sign. No other Code provisions required that an income tax return preparer disclose to the IRS whether he was in the business of preparing returns or what returns he had prepared.

In addition, most penalties set out in the Internal Revenue Code for improperly prepared returns were penalties which related to improper tax return preparation by the taxpayer himself and not by a paid preparer. Under these provisions, which continue to apply to individual taxpayers, taxpayers may be subject to criminal fraud penalties of up to $10,000 in fines and imprisonment for not more than five years for willful attempt to evade tax (sec. 7201). Taxpayers are also subject to civil fraud penalties of up to 50 percent of the amount of any underpayment of tax as well as penalties for negligence or intentional disregard of rules and regulations in an amount equal to 5 percent of any underpayment of tax (sec. 6653).

By contrast, persons who prepared returns of others for a fee were only subject to criminal fraud penalties for willfully aiding or assist-ing in the preparation of a fraudulent return. This crime was punishable by fines of up to $5,000 and imprisonment for not more than three years (sec. 7206).

Reasons for change

The past few years have seen a substantial increase in the number of persons whose business is to prepare income tax returns for individuals and families of moderate income. The Internal Revenue Service estimates that for the year 1972, 35 million taxpayers, or one-half of all those who filed income tax returns, sought some form of professional or commercial tax advice in preparing their returns. The Internal Revenue Service also estimates that in 1972 approximately 250,000 persons were engaged in the business of preparing income tax returns.

The rapid growth of the business of professional and commercial preparation of tax returns has led to a number of problems for the Internal Revenue Service. Some abuses have arisen in the preparation of wage earners' returns for a relatively small fee. In some of these cases, return preparers have made guarantees that individuals would obtain a refund because of the tax expertise of the preparer. In other cases, return preparers have suggested that a taxpayer sign a blank return (i.e., before it was prepared). Thus, the taxpayer did not look at the return or review it before it was filed. In some of these cases, the preparer either claimed fictitious deductions or increased the number of exemptions claimed in order to achieve the refund or tax liability which was promised to the taxpayer.

In 1972 and again in 1973, the IRS conducted surveys of preparers suspected of engaging in these types of conduct. For 1972, the IRS discovered that about 60 percent of the returns surveyed (or over 3,000 returns) showed significant fraud potential. In the 1973 survey, which was based on a more random selection of preparers than those checked in 1972, 22.3 percent of the returns (1,112 returns) prepared by preparers showed fraud potential. The sizable number of returns with fraud potential was partly attributable to the fact that the IRS focused on preparers suspected of improper conduct. Nonetheless, the surveys indicate that a significant number of preparers in those years had engaged in abusive practices.

Under prior law, it was difficult for the IRS to detect any individual case of improper preparation because the tax return preparer was not required to sign the return. Thus, the IRS had no way of knowing whether the return was prepared by the taxpayer or by a preparer who could be engaging in abusive practices involving a number of returns.

Furthermore, even if the IRS could trace the improper preparation of tax returns to an individual tax return preparer, the only sanctions available against such preparers were the criminal penalties of the tax law. Such criminal penalties were often inappropriate, cumbersome, and ineffective deterrents because of the cost and length of time involved in trying these cases in court. Because these criminal penalties were difficult to apply under prior law, the IRS generally proceeded against only the most flagrantly fraudulent cases involving income tax return preparers.

At the request of the Joint Committee on Taxation, the General Accounting Office conducted a study of tax return preparation by all types of tax return preparers. The GAO report, issued December 8, 1975, indicates that commercial preparers (i.e. nonprofessional preparers) on the average have not had a significantly greater tendency to make mistakes in preparing returns than have other types of preparers. For example, the GAO studied the 22,000 tax returns which were audited in depth for the year 1971 under the IRS Taxpayer Compliance Measurement Program. The GAO discovered that for all returns (excluding 1040A short form returns) with adjusted gross incomes of $10,000 and under, and for nonbusiness returns with adjusted gross incomes between $10,000 and $50,000, the percentage of tax adjustment determined from the IRS audits averaged 10.9 percent for returns prepared by commercial preparers and 10.2 percent for returns prepared by professional preparers. Other parts of the study indicate also that commercial preparers are no more likely to make more or larger mistakes on the returns they prepare than are professional preparers. This result probably occurs because most commercial preparers are generally involved only with those returns which are relatively simple to prepare, while professional preparers are generally involved with more complex returns.

It should be noted that the errors did not necessarily result from the types of abuses described above but may have resulted from differences of interpretation or other similar mistakes. Nevertheless, where the IRS determines that a certain return preparer has made erroneous interpretations of the tax law, regulation of all preparers would allow the IRS to correct these errors on all the returns prepared by that preparer. The fact that all types of preparers are about equally likely to make errors in preparing tax returns led the GAO to recommend that any regulation of tax return preparers apply equally to all preparers.

To aid the Internal Revenue Service in detecting incorrect returns prepared by tax return preparers, and to deter preparers from engaging in improper conduct, the Act includes a number of provisions requiring tax return preparers to disclose to the IRS certain information and subjecting preparers to penalties for failure to comply with the information requirements and for improper conduct in the preparation of returns.

Explanation of provision

The Act provides disclosure requirements and standards of conduct which are applicable to income tax return preparers. It gives the Secretary of the Treasury the power to impose penalties or to seek injunctions against preparers because of certain specified prohibited practices.

Definition of income tax preparer.—The Act applies to any person who is a tax return preparer, regardless of the educational qualifications or professional status of the person. An income tax return preparer means any person who prepares, for compensation, all or a substantial portion of a tax return or claim for refund. Whether or not a portion of a return constitutes a substantial portion is to be determined by examining both the length and complexity of that particular portion of the return and the amount of tax liability involved.

Generally, filling out a single schedule of a tax return would not be considered preparing a substantial portion of that return unless that particular schedule was the dominant portion of the entire tax return.

A person who prepares a return for compensation may be an income tax return preparer even though that person does not actually place the figures on the lines of the taxpayer's final tax return. A person who supplies to a taxpayer sufficient information and advice so that filling out the final tax return becomes merely a mechanical or clerical matter is to be considered an income tax return preparer. However, an individual who gives advice on particular issues of law or IRS policy relating to particular deductions or items of income will not have prepared a return with respect to those issues if the advice does not directly relate to any specific amounts which are placed on the return of the taxpayer.

The definition of income tax return preparer includes only persons who prepare the returns of others for compensation. A person who fills out a return gratuitously for a friend or a relative, for example, is not considered an income tax return preparer. In addition, a person who fills out a return for a friend or neighbor with no explicit or implicit agreement for compensation is not considered to have prepared the return for compensation even though that person receives an expression of gratitude (such as an invitation to dinner or a returned favor from the taxpayer). Also, IRS employees who provide taxpayer assistance are not tax return preparers with respect to that activity.

The term "income tax return preparer" includes the employer of persons who prepare the returns of others for compensation as well as the persons actually preparing returns.[1] In cases where more than one person aids in filling out a single return under one employer, the individual who has the primary responsibility for the preparation of the entire return or of a substantial portion of the return is usually an income tax preparer, while those persons involved only with individual portions of the return are not usually income tax return preparers. The fact that a person who prepares an entire return or a substantial portion of the return has his work reviewed by a more senior employee does not by itself mean that the person preparing the return is not an income tax return preparer.

The Act provides four specific exceptions to the definition of an income tax return preparer. First, a person is not considered a preparer merely because that person furnishes typing, reproducing, or other mechanical assistance in preparing the return. Thus, a person who provides a computerized service for filling out returns from information supplied by the taxpayers or advisors of the taxpayer is not considered an income tax return preparer if the processing done by such person is limited to mechanical calculations and processing. Second, an employee is not a tax return preparer merely because he prepares the return or a claim for refund for his employer or for employees of the employer. However, such an individual must be a regular and continuous employee of the employer and not an independent contractor. For example, an individual who maintains his own

[1] A person who retains one or more persons to prepare the income tax returns of others is an income tax return preparer whether or not the persons retained are technically considered employees or agents. The fact that the persons retained are not considered employees for purposes of other federal laws does not mean that, for purposes of this provision, the person retaining the income tax preparers is not also an income tax preparer.

accounting practice, but who every year, at the appropriate time for filing returns, is hired by an employer to prepare that employer's returns or the individual returns of officers or employees of that employer, is considered an income tax return preparer. Third, the Act provides that a person is not an income tax return preparer merely because he prepares a return or a claim for refund for any trust or estate of which that person is a fiduciary. Fourth, under the Act, a person will not be considered a tax return preparer merely because he prepares a refund claim which is filed as a result of an Internal Revenue Service audit. The fourth exception includes preparers of refund claims in three specific types of situations. The first situation arises when a taxpayer's income tax return for a year has been audited, a deficiency assessed and collected, or a notice of deficiency issued, or a waiver of restriction on assessment and collection issued after the commencement of the audit, and the taxpayer elects to challenge the Service's determination of his liability for that tax year by filing a claim for refund in order to perfect his right to a judicial resolution of the controversy. The second situation arises where determinations made in the course of an audit of a taxpayer for one tax year can affect his liability in another year. The preparation of a claim for refund for the affected year will not by itself cause the preparer of the refund claim to be an income tax return preparer under this provision of the Act. Similarly, in the third case, merely preparing a refund claim for a taxpayer whose tax liability has been affected directly or indirectly by a determination made in the audit of another taxpayer does not render the person preparing the claim for refund an income tax return preparer under this provision.

The definition of a tax return preparer relates only to returns of taxes imposed by subtitle A of the Internal Revenue Code and to claims for refund of taxes imposed by subtitle A.

Disclosure requirements and penalties for failure to make reports.— The Act requires that any person preparing an income tax return state on that return his identification number, the identification number of his employer, or both, in the manner prescribed by the Secretary. In cases of returns prepared by more than one return preparer, the Secretary may also establish rules determining which preparer or preparers are required to place their identification number on the return. The Act establishes a $25 penalty for each failure to furnish a proper identification number on a return unless a failure is due to reasonable cause and not due to willful neglect. In conjunction with this identification requirement, a failure by a return preparer to sign any return if required to do so under regulations prescribed by the Secetary, will result in a $25 penalty. However, the Act does not change prior law with respect to the Secretary's authority to require that the name of any income tax return preparer appear on any return.

The Act also requires that any income tax return preparer retain a copy of all returns prepared by him, or alternatively retain a list with respect to each taxable year of all taxpayers and their identification numbers for whom returns were prepared. The copies of the return or the list of returns prepared are to be kept by the preparer for three years. This provision, in addition to the requirement that the preparer place his identification number on the return itself, is to enable the IRS to identify all returns prepared by a specific individual in cases where the IRS has discovered some returns improperly prepared by that individual. The Act provides for a $50 penalty for each failure to keep a return or to include a return on a list of prepared returns. The maximum penalty under this provision is $25,000 with respect to any person for any return period. This penalty applies unless the failure is due to reasonable cause and not to willful neglect.

The Act also requires that employers of income tax return preparers make an annual report to the IRS listing the name, taxpayer identification number, and place of work of each tax return preparer employed during the year. For purposes of this requirement, an individual who is self-employed as an income tax return preparer, or who acts as an independent contractor (other than as an agent of another tax return preparer who files an information return which includes the agent), is required to file his own information report. The IRS may provide regulations permitting a parent corporation to file a single consolidated annual report for all of its subsidiaries and franchises. The Act, however, provides that if it is determined that the information generally required on an annual report is available to the Service from sources other than such a report, the Secretary may approve alternative compliance methods including, for example, guarantees of access to records which provide the information required by the Secretary without filing a report, or permitting a summary-type report, provided the employer keeps more detailed records available and accessible to the Service.

Failure of an employer properly to file an annual report or to comply with alternative compliance procedures will result in a penalty of $100 for each report which is not properly filed or is not made available to the Service, plus $5 for each omitted item which should have been included on any report or made available to the Service. Thus, an individual who files an incomplete report will incur a penalty of $5 for each item improperly excluded; an individual who files no report will be assessed $100 plus $5 for each item which would have been included on a properly-filed report. The maximum penalty under this provision is $20,000 with respect to any person for any report period.

The Act also requires that a tax return preparer furnish a completed copy of any return prepared by him to the taxpayer either prior to or at the same time as the return is presented to the taxpayer for his signature. This provision is intended to insure that the taxpayer receives a copy of the completed return to review its accuracy, and to insure that the final return is not signed by the taxpayer prior to its completion. A tax return preparer who fails to provide a completed copy of the return to the taxpayer at the appropriate time is subject to a penalty of $25 for each such failure unless due to reasonable cause and not to willful neglect.

The Act also requires that in the case of an individual, the taxpayer identification number required on any return is to be the individual's social security account number. This provision applies both to tax return preparers and to individual taxpayers.

Another section of the Act [2] provides in relation to this provision that States or local governing bodies charged with the administration

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[2] Sec. 6103(k)(5) of the Code, as amended by sec. 1202 of this Act.

of any tax law in their jurisdiction may obtain the social security account number or employer identification number assigned to any taxpayer upon application to the Secretary for use in fulfilling their tax administration responsibilities. This disclosure provision permits the IRS to give to State or local governing bodies charged with licensing, registering or regulating income tax preparers information contained on the annual information reports submitted to the Internal Revenue Service which identifies tax return preparers or which indicates any penalties which have been assessed. However, such information may be furnished only upon written request by the Governor or Chief Executive Officer of the State in which the governing body is located. The request must designate the body to which such information is to be furnished. The information furnished may be used by the State or local governing body only for the purposes of licensing, registering or regulating income tax return preparers. (State employees who make an unauthorized disclosure of any information furnished by the IRS may be subject to misdemeanor penalties or imprisonment for up to one year and penalties of up to $1,000 (sec. 7214(b)).)

Penalties for negligent or fraudulent preparation.—In addition to the penalties provided for failure to comply with the disclosure and information return requirements, the Act establishes new penalties for certain negligent or willfull attempts to understate a taxpayer's tax liability. These penalties are primarily aimed at detering income tax return preparers who prepare a large number of returns from engaging in negligent or fraudulent practices designed to understate a taxpayer's liability.

The Act establishes a penalty of $100 for each return on which an understatement of tax liability is caused by negligent or intentional disregard of the Federal tax law or rulings and regulations by an income return preparer. The rules and regulations to which this provision applies include the Treasury regulations and IRS rulings. The penalty applies generally to every negligent or intentional disregard of such regulations and rulings except that a good faith dispute by an income tax return preparer about an interpretation of a statute (expressed in regulations or rulings) is not considered a negligent or intentional disregard of rulings and regulations. The provision is thus to be interpreted in a manner similar to the interpretation given the provision under present law (sec. 6653(a)) relating to the disregard of rules and regulations by taxpayers on their own returns. While there may be instances in which some form of disclosure on a return revealing the legal theory or basis for the return preparer's position would be necessary to avoid penalties under section 6694(a), that would depend on all the relevant facts and circumstances in the particular case, as is true under section 6653(a).

The negligence penalty applies to the specific income tax return preparer who negligently or intentionally disregards rules or regulations. The penalty is not to be imputed to an employer of a tax return preparer solely by reason of the employment relationship; the employer or one or more of its chief officers also must have negligently or intentionally disregarded the rules or regulations if the employer is to be penalized. For example, if an employer or another employee supervises the preparation of a return by an income tax preparer, any negligent or intentional disregard of rules and regulations which occurs in connection with that return may be attributable to the person supervising the preparation of the return if that person had responsibility for determining whether or not the rules and regulations were followed, or if that person in fact knew that the rules or regulations were not followed.

The Act provides a second penalty of $500 for each return on which any understatement of liability results from a willful attempt to understate tax liability by a tax return preparer. A willful understatement of tax liability includes situations where an income tax return preparer disregards facts supplied to him by the taxpayer (or others) in an attempt to reduce the taxpayer's liability. For example, if a taxpayer states to the return preparer that he has only two dependents, and the preparer, with full knowledge of that statement, reports six dependents on the tax return, a willful attempt to understate tax liability has occurred. A willful attempt also occurs generally where an income tax return preparer disregards certain items of income given to him by the taxpayer or other persons. While the three-year statute of limitations is to apply to the assessment of the penalty for negligent or intentional disregard of rules and regulations, no statute of limitations is to apply to the willful understatement penalty.

A willful understatement of tax liability can also include an intentional disregard of rules and regulations. For example, an income tax return preparer who deducts all of a taxpayer's medical expenses, intentionally disregarding the percent of adjusted gross income limitation, may have both intentionally disregarded rules and regulations and willfully understated tax liability. In such a case, the Internal Revenue Service can assess either or both penalties against the income tax return preparer. However, the total amount collected by reason of imposing both penalties cannot exceed $500 per return. Thus, the IRS could in this and in other cases first assess the negligent or intentional disregard of rules and regulations penalty, and then at a later date, assess the penalty for the willful understatement of tax liability. But if the first penalty of $100 is collected, the later assessment for willful understatement of tax liability would be limited to $400 per tax return.

The negligence and willful understatement penalties apply only to cases where there is an understatement of tax liability. An understatement of tax liability occurs when any net amount payable with respect to any tax imposed by subtitle A of the Internal Revenue Code is understated or when any net amount of such tax which is refundable or creditable against future taxes is overstated. No final administrative or judicial determination with respect to any taxpayer is required as a condition of an understatement of tax liability. An understatement of tax can exist if it is shown in fact to exist in the proceeding against the return preparer regardless of what actions, if any, the Internal Revenue Service has taken against the taxpayer involved.

Both the negligent or intentional disregard of rules and regulations penalty and the willful understatement of liability penalty are assessed independently of any taxpayer deficiencies asserted against the income tax return preparer (and the other assessable penalties which have been discussed in connection with the disclosure requirements). Under normal IRS procedures, an investigation will be made before the assessment. A revenue agent's report will be filed, followed by a thirty-day letter to the income tax preparer notifying him of the proposed penalty and giving him an opportunity to pursue administrative remedies prior to the assessment of the penalty. After these appeals are exhausted, if the IRS assesses the penalty, it must make a statement of notice and demand (separate from any taxpayer notice of deficiency) to the income tax return preparer. The penalty is payable upon assessment.

An income tax return preparer can appeal the assessment of the penalty by paying the amount assessed and filing a claim for a refund.[3] If the refund claim is denied by the Internal Revenue Service, the income tax return preparer can appeal that denial to the courts.

In addition to this refund procedure, the Act provides that an income tax return preparer can appeal an assessment of the penalty if he pays 15 percent of any penalty within thirty days of the notice of assessment and files a claim for a refund at that time. During the period when the claim for refund or appeal of any refusal to refund is pending, the Internal Revenue Service may not proceed to collect any part of the remaining 85 percent of the penalty. However, with respect to any penalty for which the 15 percent amount is not paid, the Internal Revenue Service is free to pursue collection.

If the Internal Revenue Service denies a claim for refund of the 15 percent of the penalty assessed, the income tax return preparer may appeal the matter to the appropriate U.S. district court within thirty days and avoid any further IRS collection of the remaining 85 percent of the penalty. If the IRS does not rule on a claim for refund by the end of six months after the time the claim is presented, the preparer can sue in the appropriate U.S. district court within thirty days after the end of the six-month period. In such a suit, the Internal Revenue Service need not file a counterclaim for the remaining 85 percent of outstanding penalties because any court decision with regard to the refund of 15 percent of the penalty will apply equally to the remaining 85 percent. If the preparer does not begin a suit within the thirty-day period, the IRS can proceed with collection of the remaining 85 percent of the penalties.

In any trial on the merits of assessed penalties, the IRS bears the burden of proof if the penalty assessed is for willful understatement of tax liability. If the penalty is for intentional or negligent disregard of Internal Revenue Code rules or regulations, the preparer bears the burden of proof. However, if a preparer can show that his normal practice with respect to the treatment of a particular income or deduction item was not negligent and if there is evidence that his normal practice was followed, the preparer will be considered to have met his burden of proof unless the Service presents contrary evidence. For example, if a tax return preparer prepared returns for 10 years based on a revenue ruling which the Service revoked during the fifth year, the preparer would be considered negligent at least with regard to returns prepared

[3] If the income tax return preparer pays the entire amount of the penalty, a claim for refund can be filed at any time within three years after the time the penalty is paid.

in accord with the ruling for the sixth, seventh, eighth, ninth and tenth years, and (depending upon the facts and circumstances) perhaps also for the fifth year.

In the case of any claim for refund based on the 15-percent payment, the IRS may resume its collection activities only upon final resolution of the matter. Final resolution includes any settlement between the Internal Revenue Service and the income tax return preparer, or any final decision by a court, and includes the types of determinations provided under existing law (sec. 1313(a)) relating to taxpayer deficiencies. During any period of appeal of any assessed penalty for which the IRS is prevented from pursuing collection of the remainder of the penalty, the running of the statute of limitations for collection is suspended.

Regardless of whether or not the penalties assessed are appealed by the income tax preparer, any payment of such penalties will be refunded to the income tax return preparer if it is determined by final administrative or judicial action involving the taxpayer that there was no understatement of liability in the case of the return for which the penalty was assessed. For example, if an income tax return preparer pays the penalty with respect to a specific return and at a later date the taxpayer obtains an administrative or judicial determination to the effect that no understatement of tax existed on his return, a refund of the penalty shall be automatically provided to the income tax return preparer. The Internal Revenue Service is to make this refund to the income tax return preparer whether or not a request for the refund is made by the preparer and regardless of the running of any statute of limitations.

In addition, the Act establishes a civil penalty of $500 against any income tax return or claim for refund preparer who endorses or otherwise negotiates (directly or through an agent) any check which is issued with respect to any return which he has prepared with regard to taxes imposed by subtitle A of the Internal Revenue Code and which is issued to a taxpayer other than the income tax return preparer. The provision is to apply to endorsements (such as forgeries) or other negotiations which were illegal under prior law (and which continue to be illegal) as well as to previously legal transactions where a return preparer endorses or negotiates a check issued to another taxpayer (for example, by reason of a power of attorney or because of a specific or bearer endorsement by the taxpayer). This penalty applies whether or not the return preparer endorses or negotiates the check directly or through some other person (other than the taxpayer) as agent on his behalf. However, the penalty is not intended to apply to subsequent endorsements made as part of the check clearing process through the financial system, provided the check's initial endorsement or negotion was proper, i.e., provided the check was not endorsed or negotiated by a taxpayer who was an income tax return preparer with respect to the return or claim for which the Service issued the check.

Power to seek injunctions.—The Act grants the Secretary the power to seek an injunction prohibiting an income tax return preparer from engaging in specific practices or from acting as an income tax return preparer. The Secretary may bring suit in the United States District Court for the district in which the preparer resides, or in the district in which the taxpayer's principal place of business is located, or the district in which the taxpayer whose return is the basis for the action resides.

An injunction may be sought whenever the Secretary believes that an income tax return preparer has engaged in conduct subject to monetary penalties under the provisions of the Act, has engaged in conduct subject to criminal penalties under the Internal Revenue Code, has misrepresented his eligibility to practice before the Internal Revenue Service, has misrepresented his experience and education as an income tax return preparer, has guaranteed the payment of any tax refund or the allowance of any tax credit, or has engaged in any other fraudulent or deceptive conduct similar in nature to the above types of conduct which substantially interferes with the proper administration of the internal revenue laws. If the court believes injunctive relief is appropriate, it may enjoin an income tax return preparer from continuing to engage in such conduct. If the court determines that a preparer has continually or repeatedly engaged in any such conduct and that an injunction prohibiting only the specific type of conduct would not suffice to prevent interference with tax administration, the court may enjoin the preparer from engaging in business as a tax return preparer.

The Secretary may seek such an injunction without regard to whether or not penalties have been or may be assessed against any income tax return preparer. Thus, it is permissible for the Secretary both to assess penalties against a taxpayer for certain acts and to seek an injunction prohibiting the tax return preparer from engaging further in such conduct or from acting as an income tax return preparer.

The injunctive relief sought by the Secretary must be commensurate with the conduct which led to the seeking of the injunction. For example, if an income tax return preparer, who is only experienced in preparing individuals' returns, overstates his qualifications as a preparer by claiming expertise in the preparation of corporate returns, it is anticipated that any injunction would be directed toward the misrepresentation itself or the preparation of corporate returns and not toward preventing the preparer from preparing any returns at all. Furthermore, if some of an employer's employee-preparers have engaged in conduct leading to a request for an injunction against the further preparation of returns, the injunction sought is to apply only against those preparers and not the employer (or other employees), unless the employer (or other employees) is actively involved in the improper conduct. Nothing in this provision alters the inherent authority of the courts to limit the scope and duration of any injunction as is deemed appropriate with respect to the actions leading to the request for injunctive relief.

To the extent permitted under the Federal Rules of Civil Procedure, the Secretary may seek a temporary restraining order on an *ex parte* basis under this provision. However, the Secretary is to seek such an order only in those extreme cases where the administration of the tax laws would be irreparably harmed by the continuation of the conduct against which the restraining order is sought.

An income tax return preparer may, however, prevent the Secretary from initiating or pursuing an injunctive action based on the penalties provided for in this Act if the preparer files with the Secretary a bond of $50,000 as surety for the payment of any of the penalties which might be assessed. The bond need not be continued if the penalties which gave rise to the injunctive action have been assessed and paid.

Effective date

This provision applies to documents prepared after December 31, 1976.

Revenue effect

This provision will not have any revenue impact.

4. Jeopardy and Termination Assessments (sec. 1204 of the Act and secs. 6851, 6863, and 7429 of the Code)

Prior law

Under normal assessment procedure, there is generally a considerable lapse of time between a taxpayer's first notice that the Internal Revenue Service is seeking to collect taxes from him and the actual enforced collection of those taxes. For example, a taxpayer who does not agree with a proposed assessment of income taxes may pursue administrative appeals within the Service, and, if no agreement is reached, the taxpayer may petition the Tax Court after the Service has issued a notice of deficiency, all without paying the tax allegedly due. On the other hand, when the Service determines that the collection of a tax may be in jeopardy, it may forgo the normal time-consuming assessment and collection procedures and immediately assess and collect the tax. For this purpose, there are two basic types of special assessments—jeopardy assessments and termination assessments.[1]

Jeopardy assessments are of two different types depending on whether the taxes involved are (1) income, estate, gift, or certain excise taxes (those taxes that are normally dealt with under the notice of deficiency procedures) or (2) other taxes (such as employment taxes and wagering taxes).

Use of jeopardy assessments related to income, etc., taxes.—If the Service determines that the collection of income, estate, gift, or certain excise taxes is in jeopardy, a jeopardy assessment may be made under section 6861 of the Code. Under such an assessment, the Service determines that a deficiency exists and that its assessment or collection would be jeopardized by the delay. The Service is then authorized immediately to (1) assess the tax, (2) send a notice and demand for payment, and (3) levy upon the taxpayer's property for its collection. The 10-day waiting period normally required between demand for payment and seizure of the taxpayer's property does not apply in this case. However, if the jeopardy assessment is made before the statutory notice of deficiency is sent to the taxpayer, the Service is required to send the notice within 60 days after the jeopardy assessment is made.

The judicial remedies available to a taxpayer who has been subject

[1] The Internal Revenue Manual states that a jeopardy or termination assessment should not be made unless at least one of the following three conditions is met:

(1) The taxpayer is or appears to be designing quickly to depart from the United States or to conceal himself;

(2) The taxpayer is or appears to be designing quickly to place his property beyond the reach of the Government either by removing it from the United States, or by concealing it, or by transferring it to other persons, or by dissipating it; or

(3) The taxpayer's financial solvency appears to be imperiled.

to a section 6861 jeopardy assessment are identical to the remedies available for a normal assessment. Upon receiving a notice of deficiency, the taxpayer may file a petition for redetermination in the Tax Court.[2] Alternatively, the taxpayer may pay the full amount of the deficiency, file a claim for refund with the Service, wait 6 months (unless the claim is denied by the Service sooner), and then file a refund action in a Federal district court or the Court of Claims.

Under prior law, the taxpayer who had been subjected to a jeopardy assessment, however, did not have all the protection afforded the ordinary taxpayer during the judicial review. In the normal deficiency case, the Service has been prohibited from making an assessment and taking collection action against a taxpayer's property prior to the time allowed for filing a petition for redetermination and during the time litigation is pending in the Tax Court. Although the Service has generally been precluded from selling any property seized prior to or during Tax Court litigation, the jeopardy taxpayer—unlike the ordinary taxpayer—lost the use of whatever property had been seized by the Service while relief was being sought in the Tax Court.

Use of jeopardy assessments relating to other taxes.—If the Service determines that collection of any tax liability relating to a tax other than an income, estate, gift, or certain excise tax is in jeopardy, the Service may make a jeopardy assessment under section 6862. This type of jeopardy assessment differs from a jeopardy assessment under section 6861 in that the taxpayer does not have the right to appeal the Service's determination to the Tax Court because the Tax Court has no jurisdiction in cases involving the types of taxes covered by section 6862.

As in the case of a section 6861 jeopardy assessment, if the Service determines that a tax is due and that the assessment or collection of the tax would be jeopardized by delay, the Service is authorized to immediately assess and levy upon the taxpayer's property. However, under prior law, unlike the prohibition that prevented the Service from selling any property seized under a section 6861 jeopardy assessment before Tax Court appeal rights were exhausted, property seized as a result of a section 6862 jeopardy assessment (since the case cannot be taken to the Tax Court) can be sold before the taxpayer has a right to contest the tax liability.

The appeal rights for a taxpayer who has been subject to a section 6862 jeopardy assessment begin after payment of the tax and filing of a claim for refund with the Service. The taxpayer must wait 6 months—unless the Service denies the claim sooner—and then either the Federal district court or Court of Claims will consider a refund suit by the taxpayer.

Use of termination assessments.—The two types of jeopardy assessment discussed up to this point are used only where the deficiency is determined after the end of the taxable year to which it relates. A termination assessmen (sec. 6851 of the Code) may be made when the collection of an income tax is in jeopardy before the end of a taxpayer's normal tax year or before the statutory date the taxpayer is required to file a return and pay the tax. Under a termination assessment,

[2] The notice is a jurisdictional prerequisite to litigation in the Tax Court.

which may be made only to collect income taxes, if the Service finds that the collection of a tax is in jeopardy, it is authorized to:

(1) serve notice on the taxpayer of the termination of his taxable period;

(2) demand immediate payment of any tax determined to be due for the terminated period; and

(3) if payment is not received, immediately levy upon the taxpayer's property.

Any amount collected as a result of the termination assessment is credited against the tax finally determined to be due for the taxpayer's full year liability. The 10-day waiting period normally required between demand for payment and seizure of the taxpayer's property does not apply when a termination assessment is made.

In recent years there has been considerable litigation and confusion concerning the judicial remedies of taxpayers who were subject to termination assessments under prior law. It has been the Service's position, in the case of termination assessments, that its authority to assess has *not* been limited by requirements (such as found in section 6861) that the Service must send to the taxpayer a deficiency notice within 60 days after assessment. Thus, under the Service's position, a taxpayer who had been subject to a termination assessment could have contested the assessment only by (1) paying the assessed tax, (2) filing a claim for refund with the Service, and (3) after 6 months, unless the refund claim was denied sooner, filing a refund action with the Federal district court or Court of Claims. Since it also has been the Service's practice not to consider a refund claim until after the end of the taxpayer's normal tax year, there could have been in some cases a considerable delay until the taxpayer could obtain judicial review of his case, and during this delay the taxpayer was deprived of the use of any refund to which he would be entitled. Before the *Laing* decision (see footnote 3, below), some courts had sustained the Service's position, and other courts had rejected it.

On January 13, 1976 (after H.R. 10612 was passed by the House), the Supreme Court held [3] that when a taxpayer has been subjected to a termination assessment, the Service was required to send the taxpayer a notice of deficiency within 60 days after assessment (see footnote 2, above). In addition, the Court held that the Service had no authority to sell property seized pursuant to a termination assessment before the taxpayer has had an opportunity for judicial review of the tax liability in the Tax Court.

In recent years, most taxpayers who have been subject to termination assessments have been suspected of dealing in narcotics. Particularly during 1972 and 1973, a concerted effort was made to utilize termination assessments to "reduce the profitability" of dealing in illegal drugs. In 1974, however, the Service revised its guidelines to emphasize that termination assessments (and jeopardy assessments) were to be utilized to achieve maximum compliance with the internal revenue laws rather than to attempt to disrupt the distribution of narcotics.

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[3] *Laing* v. *United States*, 423 U.S. 161, 96 S. Ct. 473, 76–1 USTC par. 9164, 37 AFTR 2d 76–530 (1976).

Reasons for change

As a result of concern in this area, the Joint Committee on Taxation, on December 27, 1974, requested the General Accounting Office to act as its agent in reviewing the procedures followed by the Internal Revenue Service in making jeopardy assessments. The review was to include how the Service uses these enforcement tools, how often they are used, and whether their use varies significantly from district to district. Because of the time schedule of Congressional tax reform consideration, the GAO expedited its review and therefore limited its work to two IRS districts. The GAO has recently submitted its report to the Joint Committee.[4]

The GAO report indicated that most jeopardy assessments and termination assessments were utilized against taxpayers allegedly engaged in illegal activities, although some of the jeopardy assessments under section 6862 were utilized to collect penalty taxes from persons who had failed to collect, or pay over, employment taxes. Although the GAO generally concluded that these types of assessments had not been misused, it did note that the termination assessments were generally unproductive from a tax collection viewpoint, since in 40 cases which had been completed as of March 1976, $1,254,233 was assessed but the total tax deficiency after audit was only $220,677 (17.6 percent of the assessments). The GAO also noted that, in at least one case where a section 6862 jeopardy assessment was used to collect penalty taxes resulting from a corporation's failure to pay employment taxes, it was at least possible that the taxpayer was not liable for payment of the penalty tax.

The jeopardy and termination assessment powers granted to the Internal Revenue Service are generally considered valuable enforcement tools which the Service can effectively utilize in unusual circumstances to prevent taxpayers from avoiding the payment of taxes. However, a taxpayer who has been subjected to such an assessment may suffer considerable hardship from the suddenness with which action may be taken.

Hardship may also result because of the requirement that, if the assessment is made under section 6862 (jeopardy assessment for other than income, estate, or gift tax, or certain excise taxes), the taxpayer must pay the tax, file a claim for refund, and then wait six months before filing a suit for refund. In addition, property seized following a jeopardy assessment under section 6862 can be sold before the taxpayer can contest the tax liability.

Since a taxpayer subjected to a section 6851 termination assessment or a section 6861 jeopardy assessment must be mailed a deficiency notice within 60 days after the assessment, the problem is less acute in this case than in the case of a taxpayer subjected to a section 6862 assessment. However, since, even in the case of a termination assessment or a section 6861 jeopardy assessment, a taxpayer may have to wait at least 60 days to petition the Tax Court and then his case will be placed on the regular docket of the Tax Court, his judicial remedy (considered in the light of the fact that substantially all of his assets

[4] "Use of Jeopardy and Termination Assessments by the Internal Revenue Service," submitted July 16, 1976. (GAO had submitted a draft of its report to the House Committee on Ways and Means during its markup of the reform legislation in September 1975.)

may have been seized) is not sufficiently speedy to avoid undue hardship in cases where the assessment may have been inappropriate.

Furthermore, some have argued that under prior law a taxpayer's rights for review of the Service's action were constitutionally inadequate. That argument was based on the premise that, in view of the hardship that could have been suffered by a taxpayer who was the subject of a jeopardy or termination assessment, it was not sufficient to provide that within 60 days a taxpayer could have filed a petition with the Tax Court which generally could be expected to render an opinion within 12 to 30 months after the petition was filed.

On March 8, 1976, the Supreme Court decided the case of *Commissioner v. Shapiro* 424 U.S. 614–761 USTC par. 9266, 37 AFTR 2d 76–959 (1976), involving an interpretation of the Anti-Injunction Act (section 7421 of the Code) with respect to a taxpayer against whom a jeopardy assessment had been made. In this case, the Supreme Court rejected the Commissioner's position that he "has absolutely no obligation to prove that the seizure has any basis in fact no matter how severe or irreparable the injury to the taxpayer and no matter how inadequate his eventual remedy in the Tax Court." (424 U.S. at 630.) The Supreme Court also indicated that, at least in certain circumstances, a taxpayer may be constitutionally entitled to a more rapid judicial or administrative review of the Service's basis for a seizure of assets pursuant to a jeopardy asessment than is provided by his right to petition the Tax Court under the normal Tax Court procedures. In its opinion (at footnote 12), the Supreme Court also stated:

> "Nothing we hold today, of course, would prevent the Government from providing an administrative or other forum outside the Art. III judicial system for whatever preliminary inquiry is to be made as the basis for a jeopardy assessment and levy."

Under the circumstances, Congress felt that a taxpayer should be able to obtain judicial review of the propriety of a jeopardy assessment or a termination assessment on an expedited basis and also that assets levied on by reason of any jeopardy assessment or termination assessment should not be sold prior to or during the pendency of this judicial review. Also, Congress believed that the rules relating to the possible creation of multiple short taxable years by reason of termination assessments needed to be revised.

Explanation of provisions

The Act adds a new provision (sec. 7429) which provides for expedited administrative and judicial review of jeopardy and termination assessments. Under this new procedure, within five days after the date on which a jeopardy or termination assessment is made, the Service is required to give the taxpayer a written statement of the information upon which the Service relies in making the assessment. Within 30 days after the statement is furnished (or required to be furnished), the taxpayer may request the Service to review the propriety of the jeopardy or termination assessment. After such a request is made, the Service is to determine (1) whether the making of the jeopardy or termination assessment is reasonable under the circumstances and (2) whether the amount assessed is appropriate under the circumstances. In making these determinations, the Service is to take into account not only information available at the time the assessment is made but also information which subsequently becomes available.[5] If the Service finds that the assessment is inappropriate or excessive in amount, it may abate the assessment in whole or in part.[6]

If the taxpayer is not satisfied with the results of the administrative review, he may, within 30 days after the Service makes a determination on his request (or, if earlier, within 30 days after the 16th day after the request for administrative review was made), bring an action in the United States District Court for the district in which he resides. Within 20 days after the commencement of this action, the district court is to make independent, *de novo* determinations as to (1) whether the making of the jeopardy or termination assessment is reasonable under the circumstances, and (2) whether the amount assessed or demanded is appropriate under the circumstances. In making these determinations, the court is to take into account not only information available to the Service at the time of the assessment but also any other information which bears on these issues. The court has authority to effectuate its determination by ordering, where appropriate, the abatement of the assessment (in whole or in part) or by other appropriate relief. The 20-day period may be extended by not more than 40 additional days at the request of the taxpayer, but may not be extended at the request of the Treasury Department or the court. It is further provided that a determination by the district court may not be appealed to or reviewed by any other court.

In this court proceeding, the Treasury Department has the burden of proof as to whether the making of the jeopardy or termination assessment is reasonable.[7] If an issue is raised as to the reasonableness of the amount assessed, the Treasury Department is required to provide a written statement (such as in its answer to the taxpayer's petition) setting forth its basis for determining the amount assessed, but the taxpayer is required to bear the burden of proof. This is similar to the division of burden of proof in civil fraud cases. The burden of proof as to the reasonableness of making a jeopardy or termination assessment is placed on the Treasury Department because the making of a jeopardy or termination assessment involves more severe consequences to the taxpayer than a normal assessment, and the imposition of these consequences differs substantially from normal assessment and collection procedure. However, the Treasury Department is not required to carry its burden of proof in the court review of a jeopardy or termination assessment under the special evidentiary standard of proof applicable to proving civil fraud, i.e., "clear and convincing evidence." Rather, the usual standard is to apply, as it does where the government is given the burden of proof in a deficiency case on a tax issue it failed to raise in its notice of deficiency.

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[5] Since the Service (and the court) may rely on information which becomes available after the making of the assessment, the abatement (in whole or in part) of a jeopardy or termination assessment does not necessarily imply that the Service acted improperly in making the assessment.

[6] Both the Service and the court are intended to have discretion to abate an assessment (in whole or in part) even if the assessment is not found to be inappropriate or excessive if there is a finding that the taxpayer would suffer unusual hardship.

[7] The Congress believes that the general standards set forth in the Internal Revenue Manual relating to the conditions which must exist before a jeopardy or termination assessment is made are reasonable. (See footnote 1, above, for the standards provided in the manual.)

In determining whether the amount assessed is appropriate under the circumstances, the court is not expected to attempt to determine ultimate tax liability. Rather, the issue to be determined is whether, based on the information then available, the amount of the assessment is reasonable. Thus, for example, in the absence of other evidence made available to the Internal Revenue Service before the proceeding or during the proceeding, an assessment of an estimate of the taxpayer's liability to date based on information in fact available to the Internal Revenue Service will be presumed to be reasonable.

A determination made under new section 7429 will have no effect upon the determination of the correct tax liability in a subsequent proceeding. The proceeding under the new provision is to be a separate proceeding which is unrelated, substantively and procedurally, to any subsequent proceeding to determine the correct tax liability, either by action for refund in a Federal district court or the Court of Claims or by a proceeding in the Tax Court.

The requirement that the Service give the taxpayer a written statement of the information upon which it relied in making the jeopardy or termination assessment and the provision for administrative review are provided because Congress believed that this statement to the taxpayer and an opportunity for administrative review will allow the taxpayer and the Service to exchange information and, in most cases, either to work out a solution satisfactory to both parties or at least to facilitate the court proceeding. These provisions could delay court review for only 20 days, and, in the judgment of Congress, the delay appears to be more than counterbalanced by the likelihood that the court proceedings would be facilitated by the exchange of information and that some court proceedings could be avoided entirely.

The Act provides for expedited review of jeopardy and termination assessments by the district court because it is contemplated that taxpayers would find it easier and more convenient to bring an action in the district courts rather than in the Tax Court. In addition, since the Tax Court does not have permanent facilities (or judges or commissioners sitting) throughout the country, review of these procedures is likely to be less of a burden if placed in the district courts.

The Act also provides that, during the period necessary to complete administrative review, and, if administrative review is sought, during the period necessary to seek judicial review, property seized pursuant to a jeopardy or termination assessment may not be sold unless (1) it is perishable, (2) the taxpayer consents, or (3) the expenses of conservation or maintenance would greatly reduce the net proceeds. Where judicial review is sought, these restrictions also apply during the period until a judicial determination is made.

The Supreme Court in the *Laing* case held that, since restraints on section 6861 also applied to assessments under 6851, property seized pursuant to a termination assessment could not be sold prior to an opportunity for Tax Court review of the amount of tax liability, and if a petition is filed in the Tax Court, prior to the completion of the action on the tax liability. The Act follows this decision in this respect except that the restrictions on sale expire on the due date of the return (taking into account any extensions) if no return is filed by that date.

Since the Act provides this special proceeding whereby the taxpayer can have both administrative and judicial review of the appropriateness of the jeopardy or termination assessment within as few as 40 days after the making of such assessment, Congress believed it is appropriate to provide that the making of a termination assessment does not terminate a taxable year, create a deficiency, or require the Service to give the taxpayer a notice of deficiency within 60 days of a termination assessment. The decision in the *Laing* case interprets prior law to require such a notice within 60 days of the making of the termination assessment since it regards the amount assessed pursuant to such an assessment as a deficiency. This approach, however, would have the effect of requiring courts to make a determination of tax liability based upon less than a full taxable year. Such a determination appears to be inconsistent with the provisions of section 6851(b) (prior to its amendment) allowing the taxable year to be reopened after termination until its normal end if the taxpayer has income after the termination. The requirement of multiple short taxable years could not only create administrative problems for the Service, but also could result in detriment to the taxpayer whose income tax liability might be greater because of the multiple years.[8]

Therefore, the Act revises section 6851 to provide that a termination assessment does not end the taxable year for any purpose other than the computation of the amount of tax to be assessed and collected. Also, the language relating to reopening of a taxable year is eliminated. This has the general effect of treating amounts assessed and collected pursuant to termination assessments in a manner similar to the collection of estimated taxes. Such an enforced collection, however, is subject to the administrative and judicial review described above, but it does not have the effect of terminating the taxpayer's taxable year. Rather, such taxable year continues until its normal end.

Congress believes it is appropriate to allow a taxpayer who has been subjected to a termination assessment to contest the ultimate issue of his tax liability in the Tax Court in the same manner as is provided with respect to a taxpayer who has been subjected to a jeopardy assessment. Consequently, the Act provides that within 60 days after the later of the due date of the taxpayer's return for the full taxable year or the date on which the return is actually filed, the Service must send the taxpayer a notice of deficiency.[9]

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[8] Thus, for instance, gambling winnings can be offset by gambling losses only within the same taxable year. Consequently, if a gambler were the subject of a termination assessment, he might well be worse off with two short taxable years than a full taxable year. Also, a number of complicated issues might well have to be faced, such as adjusting limitations on the number of taxable years for carryovers and carrybacks (such as those for net operating losses and the investment credit) and problems relating to annualization of the taxpayer's income.

[9] The Act also makes a number of technical changes to the code to conform to the revisions of section 6851(a) and (b) and to clarify the manner in which the tax is computed both where there is one termination assessment in a taxable year and where there are multiple terminations. Thus, for instance, it is provided that certain rules relating to jeopardy assessments also apply to termination assessments, including provisions indicating that the Service has discretionary authority to abate where jeopardy is not shown to exist (even without regard to the review process described above). The requirement of a return for the short period from the beginning of the taxable year until the date of termination assessment is repealed, and section 6091 is amended to specifically allow the Service to designate the place for taxpayers who have been subjected to termination assessments. Section 6211(b)(1) is amended to provide that the amounts collected pursuant to a termination assessment are not treated as payments which would be utilized in determining whether there is a deficiency. Further, the rules relating to a bond to stay collection of a termination assessment have been integrated with those relating to jeopardy assessments in section 6863(a).

Effective date

Under the Act, these provisions were to apply to jeopardy and termination assessments where the notice and demand takes place after December 31, 1976. However, Public Law 94–528 delayed the effective date of these provisions to apply to jeopardy and termination assessments where the notice and demand takes place after February 28, 1977.

Revenue effect

These provisions do not have any revenue impact.

5. Administrative Summons (sec. 1205 of the Act and secs. 7609 and 7610 of the Code)

Prior law

Under the tax law, the IRS is given authority, during the course of an investigation to determine the tax liability of a person, "to examine any books, papers, records, or other data which may be relevant or material" to the investigation. This includes not only the right to examine records in the possession of the taxpayer but also the authority to issue a summons to "any person" having possession or custody of records "relating to the business of the person liable for tax" as well as the authority to take the testimony of any such person under oath (sec. 7602). In certain cases, where the Service has reason to believe that certain transactions have occurred which may affect the tax liability of some taxpayer, but is unable for some reason to determine the specific taxpayer who may be involved, the Service may serve a so-called "John Doe" summons, which means that books and records relating to certain transactions are requested, although the name of the taxpayer involved is not specified (*United States* v. *Bisceglia*, 420 U.S. 141 (1975)). The summonses served by the Internal Revenue Service, which may be referred to as administrative summonses, may be enforced where necessary by appropriate court procedure.

Under prior law, where the summons was served on a person who was not the taxpayer (i.e., a third-party summons), the party summoned could challenge the summons for procedural defects (i.e., on grounds that the summons was not validly served or was ambiguous, vague or otherwise deficient in describing the material requested), on grounds of the attorney-client privilege (where applicable) and on other grounds, such as an assertion that the material subject to summons was not relevant to a lawful investigation, or that it was not possible for the witness to comply (as where the records were not in his possession). However, there was no legal requirement that the taxpayer (or other party) to whose business or transactions the summoned records related be informed that a third-party summons had been served.[1]
obtain records, etc., without an advance showing of probable cause

Reasons for change

The use of the administrative summons, including the third-party summons, is a necessary tool for the IRS in conducting many legitimate investigations concerning the proper determination of tax. The administration of the tax laws requires that the Service be entitled to

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[1] In *United States* v. *Miller*, decided on April 21, 1976, the Supreme Court held that a taxpayer had no protectable Fourth amendment interest in certain bank records maintained pursuant to the Bank Secrecy Act of 1970.

obtain records, etc., without an advance showing of probable cause or other standards which usually are involved in the issuance of a search warrant. On the other hand, the use of this important investigative tool should not unreasonably infringe on the civil rights of taxpayers, including the right to privacy.

Even prior to the enactment of this provision, the Service had instituted an administrative policy designed to establish certain safeguards in this area. Under this policy, IRS representatives were instructed to obtain information from taxpayers and third parties on a voluntary basis where possible. Where a third-party summons is served, advance supervisory approval was required. In the case of a John Doe summons, the advance supervisory approval was required to be obtained on a high level basis. The Congress decided, however, that these administrative changes, while commendable, do not fully provide all of the safeguards which might be desirable in terms of protecting the right of privacy.

The Congress believes that many of the problems in this area can be cured if the parties to whom the records pertain are advised of the service of a third-party summons, and are afforded a reasonable and speedy means to challenge the summons where appropriate. While the third-party witness also had this right of challenge, even under prior law, the interest of the third-party witness in protecting the privacy of the records in question is frequently far less intense than that of the persons to whom the records pertain.

In the case of a John Doe summons, advance notice to the taxpayer is obviously not possible. Here the Congress decided that the IRS agent should be required to show adequate grounds for serving the summons in an independent review process before a court before any such summons can be served.

Explanation of provisions

Under the Act, new requirements are imposed where an administrative summons is served on a third-party record keeper. This category is limited to attorneys, accountants, banks, trust companies, credit unions, savings and loan institutions, credit reporting agencies, issuers of credit cards, and brokers in stock or other securities. For purposes of these rules, a third-party record keeper within this category must be a person engaged in making or keeping the records involving transactions of other persons. For example, an administrative summons served on a partnership, with respect to records of the partnership's own transactions, would not be subject to these rules.

Under the Act, the Service is to be required to send notice of the summons by registered or certified mail to the person (or persons) who is identified in the description of the books and records contained in the summons as the person relating to whose business or transactions the books or records are kept.[2] For example, if the Service summons a bank to furnish records with respect to all deposits and withdrawals of the X corporation for the year 1976, the X corporation is to receive notice of the summons, because it is the records concerning the trans-

[2] Such notice is to be sent to the last known business or residential address of the person or persons so identified. (If no address is known, the notice may be left with the third-party record keeper.)

actions of the X corporation which are being examined.[3] Where more than one person is identified in the description of the records as a person the records of whose transactions are to be inspected, then all such persons are to have the right to receive notice under these provisions, and are also to have the right to challenge the summons, as discussed below.

The notice required under these rules is to be mailed not later than 3 days after the administrative summons is served on the third-party record keeper.

The Congress also expects that the Service will prepare a summary of the noticee's rights under these provisions, in layman's language, and that a copy of this summary will be enclosed with each copy of the certified notice, so that taxpayers and other noticees will not lose their right to intervention due to inadvertance or ignorance of their rights.

Under the Act, the Service is not to attempt to obtain the records covered under the summons until the expiration of a 14-day period from the date of the mailing of the notice to the taxpayer or other noticee. This is to give the taxpayer (or other noticee) [4] a 14-day period in which to notify the bank or other third-party witness not to comply with the summons. This notification may be in the form of a letter sent by certified or registered mail. A copy of this notice is to be similarly mailed within this same 14-day period to the IRS officer designated in the notice which the taxpayer receives. The notification by the taxpayer or other noticee is to be treated as timely (within the meaning of sec. 7502) if such notification is mailed within the 14-day period. Where the copy of the notification has not been received by the Service within 3 days from the close of the 14-day period, the IRS would be permitted to presume that the notification had not been timely mailed.

Of course, where the noticee does not request the third-party witness not to comply at this stage, he would still be permitted to assert such defenses as may be available to him with respect to any evidence obtained pursuant to the summons in any later court action in which the noticee was directly involved (i.e., affecting his tax liability or any criminal charges which might be brought) to the same extent that he had this right under prior law.

In cases where noticees do exercise their right to request noncompliance by notifying the third-party record keeper and the IRS, as outlined above, the Service is not to seek to inspect the books or records subject to the summons unless the Service goes into court and obtains an order, against the third-party record keeper, for enforcement of its summons. Both the third-party record keeper and the noticee are to be served with notice that an action for enforcement has been instituted.[5] The third-party record keeper could (if it chose to

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[3] Of course, the Service would not be required to send a notice to each person to whom the X corporation wrote a check during the period under examination; not only would this be impossible administratively, but the identity of these persons would not even be known by the Service until the records had been examined.

[4] Under the Act, the protection of these rules extends even if the person identified in the summons (i.e., the noticee) is not a taxpayer whose tax liability is under current investigation.

[5] Generally, the third-party witness would be served with process. The taxpayer or other noticee would be entitled to receive notice by certified or registered mail.

oppose enforcement of the order) assert such defenses as may be available to it, just as under prior law.

The noticee could also intervene in the action to enforce the summons and assert defenses to enforcement of summons which were available under prior law. In addition, the Congress intends that the noticee would have standing to raise other issues which could be asserted by the third-party record keeper, such as asserting that the summons is ambiguous, vague or otherwise deficient in describing the material requested, or that the material requested is not relevant to a lawful investigation. In other words, the Congress intends that the noticee will be allowed to stand in the shoes of the third-party record keeper and assert certain defenses to enforcement which witnesses are traditionally allowed to claim, but which might not have been available to intervenors (under many court decisions) on ground of standing.

At the same time, it should be made clear that the purpose of this procedure is to facilitate the opportunity of the noticee to raise defenses which are already available under the law (either to the noticee or to the third-party witness) and that these provisions are not intended to expand the substantive rights of these parties. Also, of course, the noticee will not be permitted to assert as defenses to enforcement issues which only affect the interests of the third-party record keeper, such as the defense that the third-party record keeper was not properly served with the summons (i.e., wrong address) or that it will be unduely burdensome for the third-party record keeper to comply with the summons.

The Congress does not wish these procedures to so delay tax investigations by the Service that they produce a problem for sound tax administration greater than the one they seek to solve. Accordingly, the Act provides that the disposition of any court actions involved be heard on as expeditious a schedule as possible.

Also, to prevent the use of this procedure by a taxpayer purely for the purpose of delay, the Act provides that in cases where the noticee is also the taxpayer whose tax liability is under investigation in connection with the summons, the statute of limitations for assessment of the taxpayer's liability for the period with respect to which the summons relates, as well as the criminal statute of limitations, is to be suspended during the period of any court action by the Service to enforce the summons.[6] Of course, this rule only applies where the noticee (who is also the taxpayer involved) has mailed notice to the third-party witness not to comply with the summons or intervenes in the court action. No suspension of the statute occurs where enforcement of the summons is only contested by the third-party record keeper. However, the statute of limitations would be suspended if the noticee staying compliance with the summons (or intervening in the court action) were the taxpayer's nominee or agent, or another person actually under the direction or control of the tax-

[6] Of course, closed years would not be reopened under these rules. The Congress expects that in the summary of rights which the Service is to send to taxpayers (and other noticees), the Service will include a description of the rules relating to the suspension of the statute of limitations, including the specific years which will be affected if the taxpayer requests third-party noncompliance with the summons and the Service subsequently seeks enforcement of its summons. Where the noticee is not the taxpayer under investigation the statute of limitations is not to be suspended, and the summary of rights is to indicate this fact.

payer. A corporation controlled by the taxpayer, for example, is covered under this rule. On the other hand, if the third-party record keeper (attorney, accountant, bank, etc.) protested enforcement of the summons, this would not suspend the statute of limitations with respect to the taxpayer because the third-party record keeper is not the notice. (Also, these persons ordinarily would not be under the actual direction or control of the taxpayer.)

In general, these rules apply in the case of a summons issued under paragraph (2) of section 7602 (general examination of books and records) as well as the specific summonses available in connection with certain credits.[7] These rules also apply in connection with testimony to be taken under summons from the third-party witness relating to these books and records.

However, this procedure will not apply in the case of a summons used solely for purposes of collection. Also, this procedure would not apply in cases where the only information requested by the Service was whether or not the third-party record keeper had records with respect to a particular person (without requesting any information contained in those records).

Thus, where the Service has made an assessment or obtained a judgment against a taxpayer and serves a summons on a bank, for example, in order to determine whether the taxpayer has an account in that bank, and whether the assets in that account are sufficient to cover the tax liability which has been assessed, the Service is not required, under the Act, to give notice to the taxpayer whose account is involved. Also, notice is not required where the Service is attempting to enforce fiduciary or transferee liability for a tax which has been assessed. (Otherwise, there might be a possibility that the taxpayer, transferee or fiduciary would use the 14-day grace period, which is provided under the provisions outlined above, to withdraw the money in his account, thus frustrating the collection activity of the Service.) However, this exception does not apply where the Service is attempting to obtain information concerning the taxpayer's account for purposes other than collection as, for example, where the Service is attempting to compute the taxpayer's taxable income by use of the "net worth" method.

The Act also provides an exception to the general rule that the Service is to furnish notice whenever it examines records of the taxpayer which are maintained by a third party to cover the situation where the Service can demonstrate to a court that compliance with the notice requirement creates a substantial possibility that the noticee may flee, engage in the destruction of records (including those in his own hands) or engage in collusion with or the intimidation of witnesses. This provision is intended to enable the Service to avoid material interference with an investigation where it reasonably believes that this might occur; however, petitions by the Service are not to be granted automatically by the courts and the petitions (and supporting affidavits) must show reasonable cause. The Congress contemplates that this will be a relatively unusual procedure, but believes

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[7] These include section 6420(e)(2) (credit for gasoline used on farms), section 6421(f)(2) (credit for gasoline used for nonhighway purposes by local transit systems), section 6424(d)(2) (credit for lubricating oil used in nonhighway motor vehicles), and section 6427(e)(2) (credit for fuels not used for taxable purposes).

this device should be available for use by the Service in cases where it can be demonstrated, to the satisfaction of a court, that there is a significant possibility that there may be a material interference with the lawful course of an investigation if the taxpayer is informed that his records are under examination.

In the case of a "John Doe" situation, where the Service has knowledge of a particular transaction or transactions which may affect tax liability, but does not know the identity of the person involved, it is obviously not possible to comply with the notice rules outlined above. Typically, when cases like this have arisen in the past, the Service has issued a "John Doe" summons to the third-party record keeper, in which the record keeper is requested to supply all information in its possession relating to such transactions (including any information which the third party may have concerning the identity of the taxpayer).

Recognizing that issues of privacy are involved in connection with the John Doe summons, the Service has made sparing use of this investigative tool. Nonetheless, there are cases where the facts of a particular case are so suggestive of possible tax liability that the Service could be remiss in its duty of collection and enforcement of the Internal Revenue laws if it did not investigate. In some such circumstances, the John Doe summons is the only practical investigative tool which is available.

Under the Act, the Service would be authorized to serve a John Doe summons following a court proceeding in which the Service established, to the satisfaction of the court that (1) the summons relates to the investigation of a particular person or group, (2) there is a reasonable basis for believing that this person or group has failed (or may fail, in the case of an investigation of a current transaction) to comply with the internal revenue laws, and (3) the information sought under the summons is not readily available from other sources and information concerning the identity of the person or group involved is likewise not readily available.

In one reported case in this area, for example, the Service discovered that a number of very old bills had been deposited in a bank, although the identity of the depositor was not known to the Service (*United States* v. *Bisceglia*, 420 U.S. 141 (1975)). The Service has also used the John Doe summons to obtain the identity of the taxpayer where, for example, an accountant has filed a "John and Mary Doe" tax return. In another case, the Service used the John Doe summons to obtain the names of corporate shareholders involved in a taxable reorganization which had been characterized by the corporation (in a letter to its shareholders) as a nontaxable transaction. In these, and similar situations, where there are unusual (or possibly suspicious) circumstances, and the Service needs to learn more details of the situation in order to determine whether tax liability should be assessed against some person (as well as the identity of the person who may be liable for tax), use of the John Doe summons may be appropriate.

While the Congress believes it is important to preserve the John Doe summons as an investigative tool which may be used in appropriate circumstances, at the same time, the Congress does not intend that the John Doe summons is to be available for purposes of enabling the Service to engage in a possible "fishing expedition." For this reason, the Congress intends that when the Service does seek court authorization to service this type of summons, it will have specific facts concerning a specific situation to present to the court.

On the other hand, the Congress does not intend to impose an undue burden on the Service in connection with obtaining a court authorization to serve this type of summons. For example, the Service is not required to show that there is "probable cause" (within the meaning of the criminal laws relating to the issuance of a search warrant) to believe that a criminal act has occurred, or even that civil fraud has occurred, or might be involved. It is enough for the Service to reveal to the court evidence that a transaction has occurred, or may have occurred, and that the transaction (in the context of such facts as may be known to the Service at that time) is of such a nature as to be reasonably suggestive of the possibility that the correct tax liability with respect to that transaction may not have been reported (or might not be reported in the case of a current year transaction, with respect to which a return is not yet due). Also the Service must convince the court that it has made a good faith, reasonable effort to explore other methods of investigation, and that use of the John Doe summons is the only practical means of obtaining the information contained in the records described in the summons.

In such circumstances, issuance of a court order authorizing use of the summons would be appropriate. Of course, the summons, when served, is to describe the particular information needed by the Service with respect to that transaction with as great a specificity as possible, in order to minimize the burden on the third-party record keeper.

The Congress contemplates that the court will review each John Doe summons to be sure that the material requested is reasonably related to the investigation, and that the summons is not overly broad in terms of the records requested.

The Act provides that the Service is not required to give notice or to follow the "John Doe" procedure where the purpose of the inquiry is simply to learn the identity of the person maintaining a numbered bank account (or similar arrangement). For purposes of these rules, a numbered bank account (or similar arrangement) is an account through which a person may authorize transactions solely through the use of a number, symbol, code name or other device not involving the disclosure of his identity. A person maintaining the account includes the person who established it and any person authorized to use the account or to receive records or statements concerning the account.

The Act also contains a provision which would authorize the Service to reimburse witnesses for the costs of complying with administrative summonses. Under these provisions the Service is required to pay per diem and mileage costs when a witness is required to appear in response to a summons and would authorize the Service to reimburse a summoned party (other than the taxpayer or his representatives) for reasonably necessary direct costs incurred in locating, copying and transporting any summoned records (other than records in which the taxpayer has a proprietary interest). Such payments and reimbursements are to be at rates, and subject to such conditions, as may be prescribed in regulations.

Effective date

Under the Act these provisions were to apply to summonses issued after December 31, 1976. However, Public Law 94–528 delayed the effective date of these provisions to apply to summonses issued after February 28, 1977.

Revenue effect

These provisions do not have any revenue impact.

6. Assessments in Case of Mathematical or Clerical Errors (sec. 1206 of the Act and sec. 6213 of the Code)

Prior law

In general, the Internal Revenue Service is required to send the taxpayer a notice of deficiency and provide an opportunity to petition the Tax Court before the Service can assess a deficiency of income, estate, or gift tax or of an excise tax imposed under the private foundations provisions (chapter 42) or under the provisions relating to qualified pension, etc., plans (chapter 43). An exception under prior law permitted the Service summarily to assess any additional tax resulting from correction of "a mathematical error appearing on the return" (sec. 6213(b)(1)). In such a case, the Service was not required to send a notice of deficiency to the taxpayer, nor did the taxpayer have a right to judicial review (through a Tax Court petition) before being required to pay the tax.

Where the Internal Revenue Service determined that a mathematical error had been made and, as a result, the taxpayer owed additional tax, an assessment was summarily made, and a notice of mathematical error which described the error was sent to the taxpayer. Under the Service's policy, before it began to collect the individual tax due on account of the apparent error, the Service permitted the taxpayer to explain why he or she believed there was no error. If the taxpayer substantiated the claim, the Service's policy was to abate any assessment which it may have made or refund any additional tax which the taxpayer may have paid. Under prior law, however, a taxpayer had no right to claim abatement of any income, estate or gift tax (sec. 6404(b)).

The term "mathematical error" had been interpreted by the Service to include several types of error which were broader in nature than literal errors of arithmetic. The Service position had been that mathematical error included the following: errors in arithmetic (such as 2+2=5); errors in transferring amounts correctly calculated on a schedule form, or another page of Form 1040, to either page 1 or page 2 of Form 1040; missing schedules, forms, or other substantiating information required for inclusion with Form 1040; inconsistent entries and computations (such as cases where total exemptions claimed do not agree with the total used in computing the tax); and errors where the entry exceeds a statutory numerical or percentage limitation (such as a standard deduction claimed in excess of the maximum allowed by the Code).

Court opinions, however, generally had limited the scope of the term, mathematical error, to arithmetic errors involving numbers which were themselves correct.

Reasons for change

Questions had been raised as to whether the Service had used its mathematical errors summary assessment powers in cases where their use was not authorized by the statute. The Service maintained that it properly used this procedure in categories of cases where most taxpayers did not dispute the Service's conclusions, thereby substantially reducing administrative and other costs.

The Service had stated that the deficiency notice procedure was significantly more costly than the mathematical error procedure, both in terms of personnel and processing costs and in terms of the cost to the Government of delays in collection of taxes. On the other hand, Congress has concluded that the Service should not be able to proceed summarily where it may have erred in its determination.

In balancing these considerations, Congress decided (1) to provide greater protection for taxpayers who wish to contest Internal Revenue Service summary assessments in mathematical error cases by restricting the Service's powers in such cases and (2) to clarify the kinds of cases in which the Service could use this restricted summary assessment authority.

Explanation of provision

The Act provides that when the Internal Revenue Service uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error (sec. 6213(b)(1)) and a period of time to require the Service to abate its assessment (sec. 6213(b)(2)(A)), and the Service is not to proceed to collect on the assessment until the taxpayer has agreed to it or has allowed the time for objecting to expire (sec. 6213(b)(2)(B)).

Definition.—The Act defines the term "mathematical or clerical error" (sec. 6213(f)(2)) to mean—

(1) an error in addition, subtraction, multiplication, or division shown on the return;

(2) an incorrect use of an Internal Revenue Service table if the error is apparent from the existence of other information on the return;

(3) inconsistent entries on the return;

(4) an omission of information required to be supplied on the return in order to substantiate an item on that return; and

(5) entry of a deduction or credit item in an amount which exceeds a statutory limit which is either (a) a specified monetary amount or (b) a percentage, ratio, or fraction—if the items entering into the application of that limit appear on that return.

Arithmetic errors.—Examples of errors in addition, subtraction, etc., include $2+2=5$ and $7-0=0$. In the usual case, such an error will be apparent and the correct answer will be obvious. However, care should be taken to be sure that what appears to be an error in addition or subtraction is not in reality an error in transcribing a number from a work sheet, with the final figure being correct even though an intermediate arithmetical step on the return appears to be wrong. It is expected that the Service will check such possible sources of apparent arithmetical errors before instituting the summary assessment procedures.

Use of tables.—An example of an incorrect use of a table is the use of a tax rate schedule X (single taxpayers) by a person who has checked line 3 of the 1975 Form 1040, indicating that the taxpayer is "married filing separately." Such a person should use the generally higher tax figures in the right-hand portion of tax rate schedule Y. In such a case, it is expected that the notification to the taxpayer will indicate that the taxpayer used the single person's rate schedule, that the taxpayer who checked line 3 on the Form 1040 should have used the married persons filing separately schedule, and the notification should show the amount of the difference in tax (indicating the amount from the married persons filing separately schedule minus the amount from the single persons schedule). The notice to the taxpayer is also to inquire whether the taxpayer is in fact married and is to inquire as to such other information which might enable the taxpayer to determine whether he or she might be eligible for a more favorable tax status even though married. For example, a person legally separated from his or her spouse may be treated as not being married for purposes of the Internal Revenue Code (sec. 2(c)) and therefore may be entitled to use the single person's schedule or the even more favorable head-of-household schedule (schedule Z).

Inconsistent entries.—This category is intended to encompass those cases where it is apparent which of the inconsistent entries on the returns is correct and which is incorrect. For example, if the taxpayer's entries as to personal exemptions on lines 6a, b, c, d, and e of Form 1040 add up to the total stated on line 6f (for example, assume that the total is "6," correctly added), but the taxpayer on line 46 of Form 1040 multiplies $750 by a different number (for example, "7"), then the Service is justified in regarding this as an error and correcting the error by multiplying the $750 for each exemption by, in the case cited above, "6." Even in this case, however, Congress expects that the Service will so phrase its notification to the taxpayer as to include questions designed to show whether the taxpayer indeed is entitled to the greater number of exemptions indicated on line 46 rather than the lesser number of exemptions indicated on line 7.

However, the summary assessment procedure is not to be used where it is not clear which of the inconsistent entries is the correct one. For example, line 6b of the Form 1040 requires the taxpayer to list, "First names of your dependent children who lived with you" and then to enter the number of those dependent children in a column for personal exemptions. If a taxpayer lists three names on line 6b but then enters "4" in the column, it is not clear whether the taxpayer miscounted (in which case the taxpayer should have written "3" in the column) or whether the taxpayer erroneously omitted the name of one of the dependent children (in which case the taxpayer's column entry of "4" would be correct). In this case, the Service should, of course, take steps to determine which entry is correct, and the taxpayer has the obligation of showing that he or she is entitled to the number of exemptions claimed. However, this summary assessment procedure is not to be used where the Service is merely resolving an uncertainty against the taxpayer.

Omissions of supporting schedules.—The next category is "an omission of information which is required to be supplied on the return to substantiate an entry on the return". The intent of this provision is to deal with situations where items should be supported by schedules which are part of the return. For example, if deductions are itemized, Schedule A should be included with the return. Similarly, Schedule G should be included if the taxpayer claims the benefits of income averaging. Also, Form 4726 should be included if the taxpayer claims the benefits of the maximum tax. Where the necessary supporting schedule is omitted from the return, then the Service may proceed under this provision by disallowing the beneficial treatment—unless the taxpayer supplies the necessary schedule. Here, too, the notification by the Service should be so designed as to encourage the taxpayer to supply the omitted schedule. If the taxpayer supplies the omitted schedule, then this justification for use of the summary assessment procedure is no longer applicable, and the supplying of the schedule is to be treated as a request for an abatement of the summary assessment. If the omitted schedule itself presents other mathematical or clerical errors (such as errors in addition or inconsistent entries), then this may be a justification for initiating a new summary assessment procedure based on those asserted errors.

Exceeding statutory limits.—The fifth category deals with deduction or credit items that exceed the statutory limit, where this is apparent from the return. This category of error occurs, for example, where a taxpayer (other than a married taxpayer filing a joint return) takes a dividend exclusion of more than $100 ($200 for joint returns) or more than the amount of the otherwise taxable dividends (sec. 116). However, this category of mathematical or clerical error does not extend to a dispute as to whether a given dividend qualifies for the exclusion (e.g., the exclusion does not apply to dividends from foreign corporations, real estate investment trusts, etc.). Another example of an error that falls into this fifth category is the claiming of a standard deduction greater than the dollar or percentage limits applicable to that taxpayer. (See the percentage standard deduction and low income allowance provisions of sec. 141.)

In the categories of cases that Congress has dealt with in this Act, not only is the error apparent from the face of the return, but the correct amount is determinable with a high degree of probability from the information that appears on the return.[1]

Abatement.—The Act (new sec. 6213(b)(2)) provides that a taxpayer who receives notice of an assessment for additional tax has 60 days (from the date the notice was sent) to file a request for an abatement of the assessment stating the disagreement with the amount of the assessment.

If the taxpayer sends such a request to the Service within the prescribed time limit, the Service must abate the assessment. During this 60-day period, the Service is not to proceed to collect upon this summary assessment. Of course, if the assessment is abated, then it never will be collected upon.

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[1] It may be argued that the category of omissions of supporting schedules departs from this general approach. As indicated above, the summary assessment in such a case is to be abated when the omitted schedule is supplied by the taxpayer; disputes as to the adequacy of the schedule that the taxpayer submits are to be dealt with under normal administrative procedures and not by use of the extraordinary summary assessment procedure (unless one of the other "mathematical or clerical errors" categories applies).

Effective date

The new summary assessment rules, together with the rights of taxpayers to require abatement of any assessments made under those rules, are to apply to income, estate, gift, private foundation, and pension tax returns filed after December 31, 1976.

Revenue effect

It is estimated that this provision will have no revenue effect.

7. Withholding Tax Provisions

a. Withholding of State and District Income Taxes for Military Personnel (sec. 1207 of the Act and secs. 5516 and 5517 of title 5, U.S.C.)

Prior law

The Secretary of the Treasury is required to enter into agreements with States which request it to withhold State income tax from Federal employees. Under prior law, however, these agreements could not apply to members of the Armed Forces.

Reasons for change

The absence of withholding has created problems for servicemen who may not know that they are subject to State income tax and may be assessed with a large deficiency when they return from active duty. In addition, in the absence of withholding, many members of the Armed Service have had difficulty making the lump sum payments required when complying with the State tax on an annual basis. There was considerable support among servicemen and other concerned groups for providing withholding of State income taxes for members of the Armed Forces.

In June 1974, the National Association of Tax Administrators (NATA) unanimously decided to advise the Federal Government of the States' desire for withholding of State incomes taxes from military pay. In 1975, the General Accounting Office (GAO) reported on this question to the Congress ("A Case for Providing Pay-as-You-Go Privileges to Military Personnel for State Income Taxes"); and pointed out that, on the basis of a limited study of compliance with State income tax by military personnel in the Washington metropolitan area (covering the income taxes of all three jurisdictions), the compliance with these income taxes by legal residents of these jurisdictions was inadequate. The report stated in part:

"The Congress should enact legislation to provide military personnel with pay-as-you-go privileges for State income taxes. Laws which permit these taxes to be withheld from Federal civilian pay prohibit such withholding on military pay. . . .

"DOD cited administrative difficulties and costs of accomplishing withholding as its principal objections. GAO recognizes it would cost the Federal Government to withhold State income taxes from military pay but similar withholding is being done with respect to civilian employees of Federal agencies and by private firms having operations national in scope."

In November 1975, the Advisory Commission on Intergovernmental Relations recommended a change in the law to provide mandatory withholding of State income taxes from military personnel. As pointed out in the October staff report on which this recommendation was based, the compliance with State income tax by military personnel is not good. As the report noted, "The absence of tax withholding contributes to the military member's uncertainty about his income tax obligation; it also makes payment of taxes more difficult and increases the temptation not to file a tax return." The report further pointed out "The absence of withholding also complicates the enforcement process for States and local governments." The report indicated that even under the arrangement whereby the military reports payroll information for military personnel to the States, compliance is poor and the information is not adequate. The commission's final report (issued in July 1976), further noted that if withholding were adopted, it would impose additional costs on the military (but no more than any private employer) and, accepting the military's estimate of $1.7 million annually to operate the system, this is only about $1 per serviceman per year. As the report points out, this compares to the estimated revenue loss to the States of $94 million from incomplete tax compliance by the military, a substantial portion of which the States would obtain if withholding were required.

The Office of Management and Budget (OMB) also expressed approval of State income tax withholding for military personnel as indicated in its August 12, 1975 letter to the GAO, which said in part:

> There is no question that the present system of withholding state and local taxes from pay of Federal civilian employees has proved to be beneficial both to the employee and to the states and local municipalities. This system makes it easier for individuals to meet their tax obligations and it also facilitates the receipt of revenues that appropriately belong to the affected states. We believe similar benefits would be forthcoming if such a withholding system was applied to military pay and that the Federal Government should provide whatever assistance is necessary to assure that such a system is developed and implemented.

As a result of these concerns, the Congress believed it appropriate to provide for the withholding of State income taxes for members of the Armed Forces.

Explanation of provision

The Act amends section 5516 and 5517 of title 5 of the U.S.C. to eliminate the prohibition against the Secretary of the Treasury entering into agreements with States and the District of Columbia to withhold State income taxes from members of the Armed Services. Thus, the Secretary of the Treasury will be required to enter into agreements to withhold State and District income taxes from members of the Armed Forces when the States or the District request such withholding from military personnel who are liable for such tax.

The Congress expects that the Secretary of the Treasury will consult with the Department of Defense and other concerned agencies in designing such agreements in view of the fact that DOD will do the actual withholding since it, not the Treasury, is the paying agent and in view of the special problems that are involved in establishing the residence for tax purposes of military personnel.

These changes do not in any way affect, or imply any change in, the existing rules which determine the situs for State income tax purposes of a member of the Armed Forces. They do not in any way imply that a State in which a member of the Armed Forces is stationed but of which he is not a resident for tax purposes may assert jurisdiction over such person. In other words, the existing rules for liability for State income tax of members of the Armed Forces are left unchanged but withholding from individuals who are members of the Armed Forces and liable for these income taxes is provided.

The Congress expects that the Department of Defense will contribute to the effective implementation of this provision by making a greater effort to instruct members of the Armed Forces in their possible liability for State income taxes and the requirements of withholding in cases where they are liable for such tax.

The Congress also expects that the Secretary of the Treasury and the Department of Defense will develop procedures for determining the residence for tax purposes of military personnel within the context of agreements the Secretary of the Treasury enters into with the States.

The burden imposed on the military by the withholding requirement is not regarded as being more burdensome than that imposed on private employers. Once the system is established for the military withholding, its operaton should not be significantly more burdensome to the military than the rules applicable to private employers. The purpose of the requirement that the burden on the Federal Government be no greater than that imposed on private employers is to prevent discrimination against the United States (as to employees) by the States. The Congress believes that this withholding is a burden which the United States should assume, both for the States and for the military and their families. Therefore, any difference in burdens is not one which comes within the purview of the requirement.

Effective date

This provision contains its own effective date in that sections 5516 and 5517 (5 U.S.C.) require the Secretary to enter into a withholding agreement 120 days after the request from the proper State official and such request cannot be made until after the date of enactment of the Act.

Revenue effect

This provision has no effect on the Federal revenues, but is expected to improve the effectiveness of individual income tax collection by the States and the District of Columbia.

b. Withholding State and City Income Taxes From the Compensation of Members of the National Guard or the Ready Reserve (sec. 1207 of the Act and secs. 5516 and 5517 of title 5, U.S.C.)

Prior law

The Secretary of the Treasury is required to enter into agreements with States and cities to withhold State and city income taxes from the compensation of Federal employees. However, under prior law the agreement could not apply to pay for service as a member of the Armed Forces.

Reasons for change

In the case of members of the National Guard or Ready Reserve who are serving in this status within the State of which they are a resident, the inability of the Federal Government to withhold State income tax from their compensation often meant they were faced either with large lump-sum payments at the time of filing or they had to make a declaration of estimated tax and pay the tax quarterly. This is the same problem which led to the adoption of the Federal withholding of State income tax for nonmilitary Federal employees in the first instance.

Explanation of provision

The Act extends the provision under prior law requiring the Treasury to enter into agreements with States, the District of Columbia and cities to withhold income taxes from Federal employees to members of the National Guard and Ready Reserve when they are paid for performing regular training.

Effective date

The prior law provision which is amended by this amendment contains its own effective date in that section 5517 (5 U.S.C.) requires the Secretary to enter into a withholding agreement 120 days after the request from the proper State official and such request cannot be made until after the date of enactment of the Act.

Revenue effect

This provision has no effect on Federal revenues.

c. Voluntary Withholding of State Income Taxes From the Compensation of Federal Employees (sec. 1207 of the Act and sec. 5517, title 5, U.S.C.)

Prior law

The Secretary of the Treasury is required to enter an agreement with a State to withhold State income tax from Federal employees in the State only if withholding State income tax is generally required of employees. The Secretary cannot enter such agreements in States where the withholding is voluntary.

Reasons for change

The prohibition against the Secretary of the Treasury entering into withholding agreements with States unless the requirement is imposed generally was designed to prevent States from imposing more stringent requirements on the Federal Government than they imposed on other employers who operated in the State. If withholding is voluntary in the case of both private employers and the Federal Government, no discrimination between them exists and the Congress sees no reason to prohibit the Federal Government from withholding State income tax from its employees.

Explanation of provision

The Act requires the Secretary of the Treasury to enter into agreements with States to withhold State income taxes from Federal employees in those States where such withholding is voluntary.

Effective date

The prior law provision which is amended by this amendment contains its own effective date in that section 5517 (5 U.S.C.) requires the Secretary to enter into a withholding agreement 120 days after the request from the proper State official and such request cannot be made until after the date of enactment of the Act.

Revenue effect

This provision has no effect on Federal revenues.

d. Withholding Tax on Certain Gambling Winnings (sec. 1207 of the Act and sec. 3402 of the Code)

Prior law

Under prior law, withholding on racetrack winnings was not required although payouts to winners of the daily double, Exacta, Perfecta and similar type pools are reportable on Form 1099 information returns if the payout is $600 or more and is based on betting odds of 300 to one or higher. Nor was withholding required for State-conducted lottery winnings.

In addition, Nevada gambling casinos were required to report certain large winnings from Keno and bingo games on Form 1099 to the Internal Revenue Service depending on the price of tickets as well as the amount won.

Reasons for change

Although most wagering transactions have no tax significance since the majority of bettors end up the year with no net wagering gains, the special types of wagers mentioned above in many cases represent unique and occasional windfalls that generally produce a significant tax liability. Even with the information reporting requirements, many taxpayers do not report these winnings on their income tax returns. One source of this nonreporting of income is, for example, the use of the so-called "10 percenters" at the racetrack. A 10 percenter is a person hired by the winner to cash his ticket for 10 percent of the winnings and provide fictitious identification so that the reporting on Form 1099 is provided in a name other than that of the actual winner. These 10 percenters themselves seldom pay any income tax.

Explanation of provision

To deal with the underreporting of gambling winnings, the Act supplements the information reporting requirement with a provision for withholding on certain winnings at a 20-percent withholding rate. The Act imposes withholding at a 20-percent rate on winnings of more than $1,000 from sweepstakes, wagering pools, and lotteries and from other types of gambling if the odds are 300 to 1 or more, with certain exceptions.

First, the withholding does not apply to winnings from slot machines, keno, and bingo.

Second, in the case of State-conducted lotteries, withholding applies only to winnings of more than $5,000. State-conducted sweepstakes and wagering pools are not included in the $5,000 exemption, but rather are treated the same as privately-conducted sweepstakes and wagering pools (and thus are subject to withholding on any net winnings exceeding $1,000). The withholding applies to the entire amount of winnings once the tests are met, not just the excess over $1,000 or $5,000. Under the Act, Congress intends that the term "wagering pools" is to include all pari-mutuel betting pools, including on- and off-track racing pools, and similar types of betting pools.

Withholding applies to winnings net of the ticket price, taking into account all tickets for identical wagers. For example, if one $100 bet and two $50 bets are placed on a single horse to win a single race, any winnings from the three tickets must be added together and the ticket prices of all three tickets must be deducted to determine net winnings. However, if the bets are placed on different horses or on different events, the net winnings are to be determined separately for each ticket.

In addition, the Internal Revenue Service is to report, prior to 1979, to the House Committee on Ways and Means and the Senate Committee on Finance on the operation of the present reporting system (IRS Form 1099) as applied to winnings from keno, bingo, and slot machines, and is to make a recommendation whether or not such winnings should be subject to withholding. In the interim, the Internal Revenue Service is to modify the reporting requirements (on IRS Form 1099) with respect to winnings from these sources. This modification should include a lower threshold for the requirement that the payor report payments to the Internal Revenue Service to the extent that current reporting practices differ from that set out in the Internal Revenue Code (sec. 6041).

Effective date

The withholding provisions apply to payments of winnings made after the 90th day after the date of enactment (October 4, 1976).

Revenue effect

This provision will increase budget receipts by $101 million in fiscal year 1977, $68 million in fiscal year 1978, and $68 million in fiscal year 1981.

e. Withholding of Federal Taxes on Certain Individuals Engaged in Fishing (sec. 1207(e) of the Act and 3121(b)(20) of the Code)

Prior law

Under prior law, the Internal Revenue Service frequently treated individuals employed on fishing boats, or on boats engaged in taking other forms of aquatic animal life, as regular employees. As a result, operators of the boats had to withhold taxes from the wages of crewmen, and also had to deduct and pay the taxes on employees under the Federal Insurance Contributions Act (the social security taxes).

Reasons for change

The crews that work on boats used in fishing and similar pursuits, such as taking shrimp and lobsters, are frequently "pickup" crews composed of individuals who may work for only a few voyages, and sometimes even for only one voyage. In some cases, the boat operator may select his crew from individuals found waiting on the dock in the morning. In still other cases, small boats may be operated by relatives, no one of whom is considered the boat operator, "captain," or even the crew's leader. Thus, the voyage partakes more of the nature of a joint venture than it does of an employment situation.

Under these circumstances, it is difficult and impractical for the boat operator to keep the necessary records to calculate his tax obligations as an employer, and it is equally difficult for him to withhold the appropriate taxes for payment. Often these boats operate with small crews, and the boat operator himself is likely to be an individual who has worked as a fisherman throughout his career, and who is unaccustomed to keeping records of any type, especially the type required under the tax rules for employers.

Another factor contributing to the difficulty in which such boat operators find themselves is the nature of the remuneration paid to their crewmen. In many cases, the crewmen are paid no regular salary, but instead receive a portion of the catch or a portion of the proceeds of the catch. In practice, the catch is often sold upon return to shore, usually by the boat operator, and each crewman is immediately paid a percentage of the proceeds of the catch that is equivalent to the portion of the catch for which he agreed to work. In view of the basic informality of these arrangements, and the consequent difficulty in adhering to the obligations required of employers by the Internal Revenue Code, Congress believes it appropriate to remove these obligations from certain small boat operators by treating their crewmen as self-employed individuals. Congress believes that this will recognize the basic nature of the arrangement between the boat operators and the crewmen since the crewmen, under these arrangements, should find it much simpler and more convenient to calculate and report their own income for tax purposes than do the boat operators.

In treating these situations as instances of employment of crewmen by boat operators, the Internal Revenue Service has not only required current payment of employment taxes by the boat operators, but has also assessed these taxes retroactively for all tax years still open under the statute of limitations. As a result of possibly sizable assessments, many boat operators may face bankruptcy. Given this possibility, Congress believes it is appropriate to extend this provision to certain prior years in cases where fishermen were not treated as employees by the boat operator or owner.

Explanation of provision

Under the Act, crewmen on boats engaged in taking fish or other aquatic animal life with an operating crew of fewer than ten are to be treated as self-employed for Federal tax purposes if their remuneration is a share of the boat's catch (or a share of the proceeds of the catch), or, in the case of an operation involving more than one boat, a share of the entire fleet's catch or its proceeds.

Crewmen described in this provision are to be treated as self-employed for purposes of income tax withholding from wages, the self-employment tax, the Federal Insurance Contributions Act (FICA) taxes, and the social security laws. They are to be treated as self-employed only if the operating crew of the boat normally consists of fewer than ten individuals (including the captain). Of course, a crewman who is self-employed by virtue of this provision for one voyage may work as a regular employee in a subsequent voyage during the same tax period on another boat, or conceivably even on the same boat. Therefore, such an individual may be both self-employed and a regular employee in his occupation as a fisherman (or in such a similar pursuit as taking lobsters or shrimp) during the same tax period.

The provision amends the definitions of employment (sec. 3121(b) of the Code), the definition of a trade or business (sec. 1402(c)), and the definition of wages for purposes of withholding (sec. 3401(a)).

In addition, amendments are made to the definitions of employment and of a trade or business in the parallel social security statutes.

This provision alleviates many of the recordkeeping requirements of the small boat operators. However, in order to permit the Internal Revenue Service to maintain a method of insuring that the crewmen to be treated as self-employed correctly report their income to the IRS, the amendment also requires boat operators to report the identity of the self-employed individuals serving as crewmen, the weight and type of the catch distributed to each crewmen, or, in cases of distributions of proceeds of the catch, the dollar amount distributed to each crewman. The operator is also to report the percentage of each crewman's share of the catch, as well as his own percentage. Furthermore, such a boat operator is also to provide each of the self-employed crewmen a written statement on or before January 31 of the succeeding year showing the information reported by the boat operator with respect to each crewman for the calendar year.

The designation of fishermen as self-employed, as provided by this provision of the Act, is for the indicated tax purpose only and is not intended to affect their rights to bargain collectively or their status under the antitrust, admiralty, or other laws.

Because the status of individuals as independent contractors or employees for Federal tax purposes presents an increasingly important problem of tax administration, the Congress joins in the request of the Senate Finance Committee (S. Rept. 94–938, p. 604) that the staff of the Joint Committee on Taxation make a study of this general area in all industries in which this problem arises.

Effective date

The classification of self-employed individuals for crewmen who meet the criteria provided by the Act is to be effective as to services performed after December 31, 1971. However, this retroactive date is not to result in requiring crewmen who have been treated as ordinary employees to pay the higher rate of social security tax required of self-employed individuals, nor are refunds of the employer's share of social security taxes to be made to boat operators in such cases. As a result, this provision will be principally effective in barring future deficiency assessments for past years which are still open under the statute of limitations. Treatment of a crewman as a regular employee (or, to be precise, treatment of his compensation as a regular employee's compensation) is to include either payment of the employment taxes, or some part of them, or withholding taxes from the crewman (with or without subsequent payment to the Internal Revenue Service). In addition, it is to be immaterial whether treatment of the crewman as a regular employee was caused or influenced by litigation or administrative procedure.

The necessary changes in the definitions of "trade or business" and "wages" are effective for taxable years ending after December 31, 1971. The new requirements for reporting to be made by boat operators with respect to payments to crewmen who are self-employed pursuant to this section of the Act are effective for calendar year 1977 and subsequent calendar years.

Revenue effect

Enactment of this provision is expected to result in a revenue loss of approximately $13 million annually beginning in fiscal 1977.

8. State-Conducted Lotteries (sec. 1208 of the Act and secs 4402 and 4462(b) of the Code)

Prior law

Under prior law, each person engaged in the business of accepting wagers was subject to an excise tax of 2 percent on the amount of wagers placed with that person (sec. 4401). The excise tax on wagers generally applied to any person who conducts a lottery. In addition, a related occupational tax of $500 per year was imposed on each person who was liable for the tax on wagers (or who was engaged in the business of receiving wagers for or on behalf of a person who was in turn, liable to pay the excise tax on wagers) (sec. 4411). Also, a special occupational tax of $250 per year was imposed on the operation of coin-operated gaming devices, including a vending machine which dispenses tickets on lotteries (sec. 4461). An exemption from the wagering tax was provided for sweepstakes or lotteries conducted by an agency of a State and in which the ultimate winners are determined by the results of a horse race.

Reasons for change

In 1963, New Hampshire became the first State in recent history to establish a State lottery. The lottery was similar in operation to the Irish Sweepstakes, so that the lottery's ultimate winners were determined by the results of a designated horse race, which was run following a preliminary selection of the prospective winners by lot. The lottery, when established, was subject to the Federal tax on wagering. In 1965, however, Congress provided an exemption from this tax in the case of State-conducted sweepstakes, wagering pools, or lotteries. The exemption was specifically based upon the New Hampshire-type of lottery and had two basic requirements: (1) the sweepstakes, wagering pool, or lottery must be conducted by an agency of a State acting under authority of State law; and (2) the ultimate winners must be determined by the results of a horse race (sec. 4402(3)).

Since the appearance of the New Hampshire lottery, several other States have established and are operating lotteries. Several more States have either authorized, or are investigating the feasibility of lottery operations. The lotteries which have been established since 1965, including a revised version of the New Hampshire lottery, differ substantially in the manner in which they operate from the form of lottery which was made exempt by Congress in 1965. Although most States use a format which gives the appearance that the ultimate winners are determined on the basis of a horse race, as a matter of fact, ultimate winners are determined by lot. Consequently, the lotteries did not satisfy the second requirement for exemption from the tax on wagers, that is, the use of a horse race to determine the winners.

The Congress believes that the exemption of State lotteries from the excise tax on wagers should be expanded to include the types of lotteries now generally used by States.

Explanation of provision

The Act deletes the requirement that the ultimate winners of State lotteries must be determined on the basis of the results of a horse race. Accordingly, all State lotteries are exempt from the wagering tax regardless of the method used for determining the winners. Futhermore, since lottery tickets may be dispensed through coin-operated vending machines, the provision also adds a similar exemption from the special occupational tax on the operation of vending machines for State-run lotteries.

Effective date

Since the Congress believes that none of the Federal taxes on wagering were intended to be imposed on State-run lotteries, the changes referred to above are to be effective for wagers made, or for periods, after March 10, 1964.

Revenue effect

This provision will forestall the collection of as yet uncollected Federal wagering taxes on State lotteries. It is estimated that the uncollected amount, which the Congress believes should not be and was not intended to be a tax liability, amounts to about $200 million.

9. Minimum Exemption from Levy for Wages, Salary, and Other Income (sec. 1209 of the Act and secs. 6331, 6332, and 6334 of the Code)

Prior law

Prior law (sec. 6334 of the Code) enumerated a relatively limited list of items of a taxpayer which were exempt from levy for taxes. The items so exempt were generally as follows: (1) wearing apparel and school books necessary for the taxpayer or members of his family; (2) if the taxpayer is the head of a family, up to $500 worth of the following: fuel, provisions, furniture, and personal effects in his household, arms for personal use, livestock, and poultry; (3) up to $250 worth of books and tools necessary for the taxpayer's trade, business or profession; (4) unemployment benefits (including any portion payable with respect to dependents); (5) undelivered mail; (6) annuity or pension payments under the Railroad Retirement Act, benefits under the Railroad Unemployment Insurance Act, special pension payments received by a person whose name has been entered on the Army, Navy, Air Force, and Coast Guard Medal of Honor roll, and annuities based upon retired or retainer pay under the Retired Serviceman's Family Protection Plan; (7) workmen's compensation payments (including any portion payable with respect to dependents); and (8) so much of the taxpayers' salary, wages, or other income as is necessary to comply with a pre-levy court-ordered judgment for support of his minor children.

Under prior law, a levy extended only to obligations which existed at the time of levy (sec. 6331(b)). Consequently, the Internal Revenue Service could levy only on salaries and wages which had been earned as of the date of the levy.[1] If the amount of such wages or salary levied upon was inadequate to satisfy the taxpayer's obligations, the

[1] Under section 6331(d), except in the case of jeopardy assessments, and initial levy could be made on the salary or wages of an individual only after he was notified in writing that such a levy was going to be made.

Internal Revenue Service was required to utilize successive levies against additional salary or wages of a taxpayer until those obligations were satisfied.

Reasons for change

Since under prior law no portion of a taxpayer's salary or wages was exempt from levy (except for court-ordered child support payments), but unemployment compensation was exempt, an employed taxpayer who was subject to a levy was substantially worse off than an unemployed taxpayer would have been under similar circumstances. In the case of an employed taxpayer subject to a levy, it appeared desirable not to encourage him to terminate his employment but rather to continue his job. As a consequence, Congress concluded that a minimum amount of a taxpayer's salary, wages or other income should be exempted from levy and such amount should be based in part upon the number of dependents of the taxpayer.

Congress further believes that the requirement of successive levies in the case of salary and wages has resulted in substantial administrative problems for the Internal Revenue Service and has not afforded individual taxpayers any significant benefit.

Explanation of provision

The Act provides an exemption from levy for a minimum amount of an individual's wages or salary for personal services, or income derived from other sources. The amount, in the case of an individual who is paid on a weekly basis, is $50 per week plus $15 per week for each of his dependents (other than any minor child of the taxpayer with respect to whom an amount is exempted from levy as a court-ordered support payment). Individuals who are paid on other than a weekly basis shall have, as nearly as possible, an equivalent amount exempt from levy under regulations to be prescribed by the Secretary. In order to deter taxpayers from claiming more dependents than those to which they are entitled, the taxpayer will have to verify the number of his dependents.

The Act provides that a levy on salary or wages of a taxpayer is to be continuous from the date the levy is first made until the tax liability with respect to which it is made is satisfied or becomes unenforceable because of the lapse of time.[2]

The Act also provides that the Internal Revenue Service must release the levy as soon as possible after the liability out of which such levy arose is either satisfied or becomes unenforceable by reason of lapse of time and is to promptly notify the person upon whom the levy was served (normally the employer) that the levy has been released.

Effective date

These provisions were to apply with respect to levies made after December 31, 1976. However, Public Law 94–528 provided that these provisions would apply only to levies made after February 28, 1977.

Revenue effect

This provision is not expected to have any revenue effect.

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[2] A conforming amendment is made to section 6332.

10. Joint Committee Refund Cases and Post-Audit Review (sec. 1210 of the Act and secs. 6405 and 8023 of the Code)

Prior law

A statutory duty of the Joint Committee on Taxation in investigating the operation and effect of the Federal tax laws is the review of cases involving refunds or credits of income, war profits, excess profits, and estate and gift taxes. Except for tentative refunds under section 6411, under prior law payment of such refunds in excess of $100,000 could not be made until at least 30 days have passed after an administrative report has been submitted to the Joint Committee.

Reasons for change

The $100,000 jurisdictional amount for refund cases reviewed by the Joint Committee on Taxation had remained unchanged for over 30 years. Inflation and the growth of the economy has caused the number of refund reports reviewed by the Joint Committee to increase substantially in recent years. For example, in 1970 there were 647 refund reports while in 1975 this number increased by over twofold to 1,434 reports. The Congress was also aware that, under prior law, the review of tax returns by the Joint Committee was generally limited to large refund cases; reviews were generally not undertaken of specific issues or cases in which large refunds were not involved. As a result, the Congress decided to increase the jurisdictional amount from $100,000 to $200,000 for refund cases which must be reviewed by the Joint Committee and to allow the Joint Committee to conduct a post-audit review on the handling of tax returns and issues generally by the Internal Revenue Service. This would allow the Joint Committee to examine more systematically the administrative enforcement of the tax laws.

It was also pointed out that Internal Revenue Code amendments made in 1969 and 1974 to impose certain taxes on private foundations and pension plans (under chapters 42 and 43) did not require that refunds of these taxes be subject to Joint Committee review. The Act adds these two areas to those subjects to Joint Committee review.

Explanation of provisions

The Act makes three changes to prior law. First, the jurisdictional amount for requirement of Joint Committee review of refund cases is increased from $100,000 to $200,000. A second provision authorizes the Chief of Staff of the Joint Committee on Taxation to conduct a post-audit review of tax returns generally. It is contemplated that this review will be done through random (or other) examination of returns and other relevant information dealing with issues which may not arise in refund cases. In addition, this is intended to assist the Joint Committee in its oversight responsibilities of the Internal Revenue Service in reviewing the IRS's auditing and other related functions and procedures with respect to the handling of tax returns. Finally, the Joint Committee's refund case jurisdiction is extended to include cases involving refunds (in excess of $200,000) of the excise taxes on private foundations and pension plans imposed under chapters 42 and 43 of the Internal Revenue Code.

Effective date

The provisions pertaining to refund reports were effective generally upon date of enactment (October 4, 1976). However, claims for refund or credit with respect to which IRS reports for Joint Committee review have already been submitted are not to be affected by the Act. The provision concerning post-audit review is effective on January 1, 1977.

Revenue effect

These provisions of the Act have no revenue effect.

11. Use of Social Security Numbers (sec. 1211 of the Act, sec. 6109 of the Code and secs. 205 and 208 of the Social Security Act)

Prior law

A person required to file an income tax return must include an identifying number in his return (sec. 6109). In general, individuals use their social security numbers for this purpose (regs. sec. 301.6109-1.)

The Social Security Act provided criminal penalties for the willful, knowing and deceitful use of a social security number for purposes relating to obtaining. or increasing the amount of, benefits under Social Security and other programs financed with Federal funds (sec. 208(g) of the Social Security Act).

Under the Privacy Act of 1974, it was unlawful for any Federal, State or local government agency to deny to any individual any right, benefit, or privilege provided by law because of such individual's refusal to disclose his social security account number, except where disclosure is required by Federal statute or is required by a Federal, State or local agency under statute or regulation adopted prior to January 1, 1975.[1]

Reasons for change

Section 6109 of the Code required taxpayers to use identifying numbers as prescribed by regulations. Although the social security number has in fact been used as the identifying number since that section was enacted in 1961, there was no provision in the Code requiring or specifically authorizing use of the social security number as the identifying number on tax returns. The Secretary of the Treasury has stated that the ability of the IRS to use social security numbers as identifying numbers for tax purposes is essential to Federal tax administration. The Congress believes that this provision is necessary to eliminate any question as to the authority of the Secretary to use these numbers.

While the Social Security Act provided criminal penalties for the wrongful use of a social security number for the purpose of obtaining or increasing certain benefit payments, including social security benefits, there was no provision in the Code or in the Social Security Act relating to the use of a social security number for purposes unrelated to benefit payments. The Congress believes that social security numbers should not be wrongfully used for any purpose.

The Privacy Act of 1974 provided that Federal, State and local agencies may not deny any individual any rights, benefit or privilege

[1] Section 7(a) of the Privacy Act of 1974, P.L. 93-579.

provided by law because such individual refuses to disclose his social security number. An exemption was provided for disclosures required by Federal statute or by a statute or regulation adopted before January 1, 1975, in regard to a Federal, State or local agency operating a system of records before that date.

The Congress has been told that State and local governments consider the use of social security numbers to be needed as a means of positively identifying taxpayers and as a means of comparing information on State income tax returns with Federal tax returns. The adoption of separate State systems of identifying numbers would be costly, duplicative and confusing to taxpayers. The Congress believes that State and local governments should have the authority to use social security numbers for identification purposes when they consider it necessary for the administration of tax, general public assistance, drivers licenses or motor vehicle registration laws.

Explanation of provision

The Act amends section 6109 to require that, except as otherwise specified under regulations, an individual shall use his social security number as his identifying number for tax purposes.

The Act also amends section 208(g) of the Social Security Act to make the willful, knowing and deceitful use of a social security number a misdemeanor for all purposes, rather than only for purposes related to benefit payments. It also makes it a misdemeanor to disclose, use or compel the disclosure of the social security number of any person in violation of the laws of the United States.

The Act amends section 205(c)(7) of the Social Security Act to establish as the policy of the United States that any State or political subdivision thereof may, in the administration of any tax, general public assistance, driver's license, or motor vehicle registration law within its jurisdiction, utilize social security account numbers for the purpose of establishing the identification of individuals affected by such laws. The State or local government may, in addition, require such individuals to furnish their social security number (or numbers, if they have more than one such number) to the State (or its political subdivision). This section further provides that, to the extent that any existing provision of Federal law is inconsistent with the policy set forth above, such provision shall be null, void and of no effect.

Effective date

The provisions of this section are effective on the date of enactment (October 4, 1976).

Revenue effect

The provision has no effect on Federal revenues.

12. Interest on Mathematical Errors on Returns Prepared by IRS (sec. 1212 of the Act and sec. 6404 of the Code)

Under prior law, interest on any underpayment of tax ran from the original due date (regardless of extensions) to the date on which payment was received.

Reasons for change

Congress felt that where a deficiency results in whole or part from a mathematical error on a return prepared by an officer or employee of the IRS acting in his official capacity to provide assistance to taxpayers, the IRS should be authorized to abate interest otherwise owing on the deficiency for the period prior to notice and demand by the IRS to the taxpayer for payment of the deficiency.

Explanation of provision

The Act authorizes the IRS to abate any portion of interest owed by a taxpayer as a result of a mathematical error on returns prepared by the Internal Revenue Service where the amount in question is below tolerance levels established by the IRS. The two principal factors to be taken into account by the IRS in establishing the tolerance levels are (1) the cost of determining, assessing, and collecting the interest and (2) sound and equitable tax administration.

Effective date

This provision of the Act applies to returns filed for taxable years ending after the date of enactment (after October 4, 1976).

Revenue effect

This provision will have only a negligible revenue loss.

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L. TAX-EXEMPT ORGANIZATIONS

1. Modification of Transitional Rule for Sales of Property by Private Foundations (sec. 1301 of the Act and sec. 101(l)(2) of the Tax Reform Act of 1969)

Prior law

The Tax Reform Act of 1969 amended the Internal Revenue Code of 1954 to impose taxes upon certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of that foundation). Among the transactions covered by these taxes on "self-dealing" are the sale, exchange, or leasing of property (sec. 4941). In order to avoid unnecessary disruption of then existing arrangements, however, the 1969 Act provided transitional rules permitting the continuation, without violation of the self-dealing, rules of any existing lease (in effect on October 9, 1969) between a foundation and a disqualified person until 1979, so long as the lease remains at least as favorable to the private foundation as it would have been under an arm's-length transaction between unrelated parties. However, for taxable years beginning after the end of 1979, the leasing arrangements must be terminated (sec. 101 (l) (2) (C) of the 1969 Act).

Another transitional rule provided in the 1969 Act permits a private foundation to sell excess business holdings to a disqualified person, if the sales price equals or exceeds the fair market value of the property being sold. However, this rule applies only to business holdings, and not to passive investments, including passive leases (sec. 101 (l) (2) (B) of the Act).

Reasons for change

Cases have been brought to the Congress' attention in which a private foundation is leasing to a disqualified person property of a nature which is peculiarly suited to the use of that person. In these cases, the value of the property to the disqualified person is greater than that to any other person. Since under the 1969 Act such a leasing arrangement must be terminated not later than the end of the last taxable year beginning in 1979, and the property could not be sold to the disqualified person by the private foundation, the foundation probably would have been put in the position of being forced to dispose of its property to unrelated persons for less than the value of that property to disqualified persons.

This particular combination of circumstances regarding the sale of leased property was not brought to the attention of the Congress when it was considering the Tax Reform Act of 1969. In effect, the sale-of-leased-property situation fell between the above-noted transitional rules. It appears likely that if this particular point had been presented in 1969, the Act would have been modified to deal with the situation. Accordingly, the Congress minimized this hardship by the addition of a new transitional rule.

Explanation of provision

The Act revises the transitional rules applicable to the private foundation provisions of the Tax Reform Act of 1969 by adding a new transitional rule to deal with the sale of property by a private foundation to a disqualified person. Under this rule, a private foundation may sell, exchange, or otherwise dispose of property (other than by lease) to a disqualified person if, at the time of the disposition, the foundation is leasing substantially all of that property under a lease subject to the 1979 lease transitional rule described above, and the foundation receives in return an amount which equals or exceeds the fair market value of the property. In computing the fair market value of the property, no diminution of that value is to result from the fact that the property is subject to any lease to disqualified persons.

The fair market value of the property is to be determined either at the time of its disposition, or at the time (after June 30, 1976) that a contract is executed for disposition of the property. The contractual valuation date permits the foundation and the purchaser to have a fixed price in their agreement even though some time may elapse and the value of the property changes between the contract and the actual settlement date.

Effective date

This provision applies to dispositions occurring before January 1, 1978, and after the date of enactment (October 4, 1976).

Revenue effect

This provision is expected to have a revenue loss of less than $5 million in fiscal years 1977 and 1978 and no revenue effect thereafter.

2. New Private Foundation Set-Asides (sec. 1302 of the Act and sec. 4942 of the Code)

Prior law

Every private foundation (other than an operating foundation, sec. 4942(a)(1)) must make "qualifying distributions" (sec. 4942(g)) of its "distributable amount"[1] for each year. If a foundation fails to distribute for charitable, etc., purposes at least the minimum required amount for a given year, the foundation is subject to a tax of 15 percent of the shortfall. This tax applies for each year that the shortfall remains to be distributed. An additional tax of 100 percent applies if the shortfall has not been distributed by the 90th day after the Internal Revenue Service has mailed to the foundation a notice of deficiency with respect to the 15-percent tax.

An amount set aside to be paid out for a specific project may be treated as a "qualifying distribution" for the year of the set-aside. But under prior law such an amount set aside could be treated as a "qualifying distribution" only if the set-aside was approved in advance by the Internal Revenue Service. To obtain such approval, the foundation had to establish both that the amounts set aside would be paid for the specific project within 5 years,[2] and that the project was

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[1] The definition of "distributable amount" is modified by section 1303 of the Act. (This is described below in 3. Reduction in Minimum Distribution Amount for Private Foundations.)

[2] The statute permits the Service to extend the payout period "For good cause shown * * *."

one which can better be accomplished by that set-aside than by the immediate payment of funds. If the Internal Revenue Service did not give timely approval of a set-aside, then the set-aside did not constitute a qualifying distribution.

Reasons for change

In some cases, the Internal Revenue Service had been reluctant to approve set-asides that were repeatedly used by a private foundation in making grants, even though the purpose for not paying the grant all at once was to allow the foundation to ensure that the funds were being properly spent. However, foundations which had similar grant programs in effect before the 1969 Act generally did not have to obtain prior approval for programs to replace them because the amounts actually distributed under such foundations' other pre-1969 Act programs still in effect and the replacement programs had been sufficient by themselves to meet the minimum payout requirements.

The Congress decided that, if a new foundation is established, or when an existing foundation's assets were significantly increased before 1972 because of a contribution,[3] then the payout rules should permit such a foundation to establish set-aside programs for projects which are designed to run several years and which require foundation monitoring. As a result of the 1969 Act set-aside rules, new foundations and some existing ones whose assets were suddenly and significantly increased could be subject to penalties for failure to fulfill payout requirements, if their new set-aside programs did not receive timely, advance Service approval. The rules thus deterred such foundations from instituting the type of long-term supervised projects conducted by many major foundations and otherwise generally favored by the Internal Revenue Code provisions on private foundations.

Explanation of provision

The ACT modifies the set-aside rules for private foundations to permit a foundation to treat as a current charitable expenditure under temporary, relaxed set-aside rules, an amount set aside to be paid out over the following five years. However, the foundation must continue to comply with the ordinary charitable expenditure requirements.

Under the Act, foundations would be permitted to set aside for subsequent payment amounts which might otherwise be required to be paid out immediately in order to avoid the penalty tax. By permitting a foundation to make set-asides in certain limited circumstances without obtaining prior Service approval, the Act alleviates a situation which was unforeseen at the time of the 1969 legislation, that is, the case of a new foundation or an existing foundation whose assets were suddenly multiplied many times over, which finds it is impossible, as a result of the Service's inaction, to meet the payout requirements in its early years if it uses the set-aside, because each set-aside grant must be specifically approved in advance by the Internal Revenue Service.

The private foundations which are expected to receive significant help from the special set-aside rules in this amendment are new foun-

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[3] In one case that has been brought to the Congress' attention, receipt of a bequest caused a foundation's assets to grow from about $100 million to about $1 billion.

dations created after 1971 and existing foundations which complete a qualifying five-year set-aside project in 1976.

The Act continues prior law in requiring, for a set-aside, that the private foundation establish to the satisfaction of the Internal Revenue Service (1) that the amount will be paid for the specific project within 5 years and (2) that the project is one which can be better accomplished by that set-aside than by immediate payment of funds. However, the Act provides an alternative to the second of the above requirements. Under this alternative, the set-aside is to be allowed if the foundation meets the first of the above requirements and also satisfies the following standards:

First, the set-aside must be for a project which will not be completed before the end of the year in which the set-aside is made.

Second, the private foundation must disburse for charitable purposes in each taxable year beginning after December 31, 1975 (or, if later, after the end of the fourth taxable year following the year in which the foundation was created [4]), not less than the foundation's distributable amount. (See footnote 1, above). For this purpose, only actual distributions (cash or its equivalent) that are made in the taxable year are taken into account. However, for this purpose all actual distributions are taken into account, even though they may be distributions of amounts that previously were given set-aside treatment.

The third standard is that during the four taxable years immediately preceding the foundation's first taxable year beginning after December 31, 1975 (or, if later, the first four taxable years after the year of the foundation's creation), the foundation must actually distribute for charitable, etc., purposes an aggregate amount not less than the sum of the following:

80 percent of the first preceding taxable year's distributable amount, plus

60 percent of the second preceding taxable year's distributable amount, plus

40 percent of the third preceding taxable year's distributable amount, plus

20 percent of the fourth preceding taxable year's distributable amount.

As under the second standard, all actual distributions made during the four-year period, and no others, are taken into account. However, in this case only the aggregate amount is relevant; it is not necessary, for example, that the distributions be matched to the distributable amounts for each separate year of the four-year period.

Fourth, if a private foundation fails in any taxable year to disburse the required amounts of cash or its equivalent and if (1) the failure was not willful and was due to reasonable cause, and (2) the foundation distributes an amount equal to that which it failed to distribute during the taxable year within the initial correction period provided

[4] A private foundation is not to be permitted to come under the rules of this provision unless it qualifies to do so at its first opportunity. For example, if a private foundation that is now in existence were in 1985 to conclude that it wishes to come under the rules of this provision for automatic set-asides, it is not to then be permitted to transfer some or all of its assets to a new private foundation and then have the new private foundation seek to comply with the rules. The "new" private foundation would be regarded, for these purposes, as having been created not later than the time the transferor foundation was created. See, for example, the provisions of Treasury Regulations § 1.507–3(a).

by statute (generally, 90 days after the Service has sent a notice of deficiency to the foundation, sec. 4942(j)(2)), then that distribution is treated (for purposes of this special set-aside rule) as though it had been made in the year in which it originally should have been made. This delayed distribution enables the foundation to continue to use this special set-aside rule. However, if this shortfall in cash distributions also results in a failure to meet the regular distribution requirements of the law, then the delayed distribution does not enable the foundation to avoid the 15-percent excise tax described above (unless the foundation also meets the technical requirement of sec. 4942 (a)(2)).

The fifth standard in the provision in effect gives the foundation a 5-year carryover of any excess disbursements it may make in any taxable year beginning after December 31, 1975. As is the case under the second, third, and fourth standards, only actual distributions made during the taxable year are taken into account for purposes of this carryover. A technical provision holds the statute of limitations on assessments and collections open during the extended payout period.

Effective date

This provision applies to taxable years beginning on or after January 1, 1975.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

3. Reduction in Minimum Distribution Amount for Private Foundations (sec. 1303 of the Act and sec. 4942 of the Code)

Prior law

Under prior law (sec. 4942), each private foundation [1] had to distribute currently for charitable, etc., purposes, the greater of all its income or an annually determined variable percentage of its average investment assets (sometimes referred to as "noncharitable assets"). Graduated sanctions were imposed in the event of failure to distribute the required amount. For taxable years beginning in 1976, the applicable percentage under prior law was 6.75 percent. This percentage was determined annually by the Treasury Department, pursuant to statutory authorization, on the basis of changes in money rates and investment yields, taking into account a standard of a 6-percent foundation payout rate for 1969 and with respect to any calendar year, comparing money rates and investment yields for 1969 with those for the immediately preceding calendar year.

The minimum distribution requirement generally had to be met for a year by making the required amount of charitable distributions in that year or in the following year.

Failure to comply with the minimum payout requirement resulted in sanctions against the foundation. The first level of sanction was a tax of 15 percent of the amount that should have been, but was not, paid out. This tax was imposed for each year until the private foun-

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[1] Different rules are provided for private foundations which are operating foundations. The changes made by this provision of the Act affect private operating foundations only in one respect. This is discussed below, under *explanation of provision*.

dation was notified of its obligation or until the foundation itself corrected its earlier failure by making the necessary payouts. However, to the extent the failure to meet the minimum payout requirement resulted from an incorrect valuation of the foundation's relevant assets and this incorrect valuation was not willful but was due to reasonable cause, then the foundation could avoid the first-level tax by promptly making additional distributions.

Within 90 days after notification by the Internal Revenue Service the foundation had to correct its failure to make the appropriate charitable distributions. This 90-day period could be extended. If the necessary distributions were not made within the appropriate period the second level of sanctions was imposed—a tax of 100 percent of the amount required to be paid out. (A penalty doubling the amount of the first or second level of tax is imposed in the case of repeated violations, or a willful and flagrant violation (sec. 6684). If an organization persistently violated the payout rules, a third-level sanction might be imposed, under which the foundation must return to the Treasury all the income, estate, and gift tax benefits received by the foundation or any of its substantial contributors (sec. 507)).

Reasons for change

The Tax Reform Act of 1969, as reported by the House Committee on Ways and Means, as passed by the House, and as reported by the Senate Committee on Finance, provided for an initial applicable percentage of 5 percent. This figure was raised to 6 percent by a Senate floor amendment and this was agreed to in the legislation which was finally enacted.

The Congress has become convinced that the original judgment of the Ways and Means and Finance Committees and of the House as to the appropriate applicable percentage, based upon the economic conditions of 1969, was correct and that the higher rate provided by the Senate floor amendment could have damaging effects on the continuing viability of many foundations. The use of 1969 money rates and investment yields for adjusting the annual rate now appears too limited a base for an economically valid income rate projection. In addition, changing the rate annually could create significant uncertainty for foundation managers in planning their grant-making programs.

Explanation of provision

The Act reduces the mandatory annual payout percentage applicable to private foundations to 5 percent and eliminates the authority of the Treasury Department to change that rate from year to year. The other provisions of prior law relating to the minimum distribution amount, including the provisions requiring distribution of adjusted net income (if that is greater than the minimum distributable amount) and the rules for corrections and sanctions, are not changed by this provision.

Private operating foundation (sec. 4942(j)(3)) are affected by the Act only in that the amendment reduces the minimum payout requirement of a private operating foundation which qualifies as such under the so-called "endowment alternative" (sec. 4942(j)(3)(B)(ii)). To qualify under this alternative an operating foundation must have an endowment[2] which, assuming a rate of return which is two-thirds of the minimum payout rate, is no more than adequate to meet its current operating expenses. The effect of the Act is to reduce the endowment alternative minimum payout rate to 3⅓ percent (two-thirds of 5 percent).

The Act also establishes certain explicit rules for valuing a private foundation's noncharitable assets in determining the required charitable expenditures (minimum investment return). In determining the value of securities for minimum charitable expenditures purposes, their fair market value (determined without regard to any reduction in value) shall not be reduced unless, and only to the extent that, the private foundation establishes that as a result of (1) the size of the block of such securities, (2) the fact that the securities are securities in a closely held corporation, or (3) the fact that the sale of such securities would result in a forced or distress sale, the securities could not be liquidated within a reasonable period of time except at a price less than fair market value. Any reduction in value shall be made only for one or more of these three reasons and shall not in the aggregate exceed 10 percent of the fair market value of the securities.

Effective date

This provision applies to taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

4. Extension of Time To Conform Charitable Remainder Trusts for Estate Tax Purposes (sec. 1304 of the Act and sec. 2055 (e)(3) of the Code)

Prior law

The Tax Reform Act of 1969 imposed new requirements which must be satisfied by a charitable remainder trust in order for an estate tax deduction to be allowed for the transfer of a remainder interest to charity. Under these new requirements, no estate tax deduction is allowable for a remainder interest in property (other than a remainder interest in a farm or personal residence) passing at the time of a decedent's death in trust unless the trust is in the form of a charitable remainder annuity trust or unitrust or pooled income fund. These rules generally apply in the case of decedents dying after December 31, 1969. However, certain exceptions were provided in the case of wills executed or property transferred in trust on or before October 9, 1969. In general, these exceptions did not apply the new rules to these wills and revocable trusts until October 9, 1972 (unless the will was modified in the meantime), to allow a reasonable period of time to take the new rules into account.

In 1970, the Internal Revenue Service issued proposed regulations with respect to the new requirements for a charitable remainder annuity trust or unitrust (under sec. 664 of the Code). These regulations provided additional transitional rules allowing trusts created after July 31, 1969, (which did not come within the statutory exceptions) to qualify for an income, estate, or gift tax deduction if the

[2] Plus any other assets not devoted directly to the active conduct of the activities for which the organization is organized.

governing instrument was amended prior to January 1, 1971. Subsequently, the date by which the government instrument had to be amended was further extended by the Internal Revenue Service.[1] On August 22, 1972, the Internal Revenue Service issued final regulations which further extended the date to December 31, 1972. On September 5, 1972, the Internal Revenue Service published Rev. Rul. 72–395 (1972–Z C.B. 340), which provided sample provisions for inclusion in the governing instrument of a charitable remainder trust that could be used to satisfy the requirements under section 664.

In 1974, Congress extended the date by which the governing instrument of a trust created after July 31, 1969, and before September 21, 1974, or pursuant to a will executed before September 21, 1974, could be amended (P.L. 93–483). Under that Act, if the governing instrument is amended to conform by December 31, 1975, to meet the requirements of a charitable remainder annuity trust or unitrust or pooled income fund, an estate tax deduction would be allowed for the charitable interest which passed in trust from the decedent even though the interest failed to qualify at the time of the decedent's death.

Where a judicial proceeding was required to amend the governing instrument, the judicial proceeding must have begun before December 31, 1975, and the governing instrument must have been amended to conform to these requirements by the 30th day after the judgment becomes final.

In any case where the governing instrument was amended after the due date for filing the estate tax return, the deduction would be allowed upon the filing of a timely claim for credit or refund (sec. 6511) of an overpayment. However, no interest would be allowed for the period prior to the end of 180 days after the claim for credit or refund is filed.

Reasons for change

Despite the additional period provided by the 1974 amendment, it came to the attention of the Congress that there are many wills becoming effective which provide a charitable remainder which still do not meet the requirements for qualifications under section 664 for a charitable remainder annuity trust or unitrust. Moreover, the Congress was informed that there are also a number of trusts and wills which were drafted after September 21, 1974, which do not comply with the new rules for the allowance of a charitable deduction for estate tax purposes.

The Congress believes it is appropriate to provide an additional 2-year extension to permit wills establishing charitable remainder trusts to be amended to comply with the 1969 Act rules for a charitable remainder for estate tax purposes because the policy of these rules is furthered when such trusts are amended to meet these rules. In addition, failure to meet these rules results in additional estate taxes that often are borne substantially by charity.

While the Congress believes that an additional extension of two years is appropriate at this time under the circumstances, the Congress believes that this should be the last extension permitted. By the end of this extension, there will have been eight years since the general effective date of the new requirements for deduction under section 2055

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[1] T.I.R. 1060 (December 13, 1970) extended the date to June 30, 1971; T.I.R. 1085 (June 11, 1971), extended the date to December 31, 1971; T.I.R. 1120 (December 17, 1971); extended the date to June 30, 1972; and T.I.R. 1182 (June 29, 1972), extended the date to the 90th day after final regulations were issued.

(e) of the Code. The Congress believes that such an eight-year period should be more than enough time for taxpayers and their lawyers to learn the new rules and to implement them into their estate plans.

Also, the Congress intends that the Internal Revenue Service make every effort to publicize to taxpayers' attorneys, trust companies, etc., the requirements of the 1969 Act with respect to charitable remainder trusts. The Congress solicits the assistance of commercial tax services in similarly publicizing these requirements.

Explanation of provision

The Act extends to December 31, 1977, the date by which the governing instrument of a charitable remainder trust created after July 31, 1969, must be amended in order to qualify as a charitable remainder annuity or unitrust or pooled income fund for purposes of the estate tax deduction. The Act also extends the date in the case of a trust created after July 31, 1969, pursuant to a will executed before December 31, 1977. Under the Act, if the governing instrument is amended by December 31, 1977, to conform to the requirements of a charitable remainder annuity or unitrust or pooled income fund, an estate tax deduction will be allowed for the charitable interest which passed in trust from the decedent even though a deduction originally was not allowed for this interest because the trust failed to qualify as a charitable remainder trust at the time of the decedent's death. This applies to trusts created after July 31, 1969. For these purposes, a trust which first became irrevocable, in whole or in part, after that date is treated as having been created after that date.

Effective date

This amendment applies with respect to decedents dying after December 31, 1969.

Revenue effect

It is estimated that this provision will decrease budget receipts by $5 million during fiscal year 1977 and 1978.

5. Income From Fairs, Expositions, and Trade Shows (sec. 1305 of the Act and sec. 513 of the Code)

Prior law

The unrelated business income tax applies to income from the conduct by an exempt organization of an unrelated trade or business. The term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income derived from such trade or business) to the exercise of its exempt purpose. The term "trade or business" includes any activity carried on for the production of income from the sale of goods or services. The law further provides that, for the purpose of defining the trade or business activity, the activity was not to lose its identity as a trade or business merely because it is carried on within a larger aggregate or similar activities or within a large complex of other endeavors which may (or may not) be related to the exempt purposes of the organization.

One major purpose of this provision is to make certain that an exempt organization does not commercially exploit its exempt status for the purpose of unfairly competing with taxpaying organizations. An example of such activity specifically cited in the law is the carrying of advertising in a journal published by an exempt organization.

Reasons for change

In two instances, the Internal Revenue Service has ruled that activities which are not conducted in competition with commercial activities of taxpaying organizations are nevertheless considered to be unrelated trade or business activities which are subject to the unrelated business income tax. In one case (Rev. Rul. 68–505, 1968–2 CB 248), the Service ruled that an exempt county fair association which conducts a horse racing meet with parimutuel betting is carrying on an unrelated trade or business subject to the unrelated business income tax. In another case the Service determined, in a series of revenue rulings (TIR–1409, 1975–2 CB 220–227), that income that an exempt business league receives at its convention trade show from renting display space may constitute unrelated business taxable income if selling by the exhibitor is permitted or tolerated at the show.

Reasons for change

The Congress does not believe that the activities dealt with in those ruling are generally unrelated to the exempt purposes of the organizations that conduct them. It is customary for tax-exempt organizations to provide entertainment, including horse racing, at fairs and expositions in order to attract the public to the educational exhibits on display. In addition, trade associations use trade shows as a means of promoting and stimulating an interest in, and demand for, their industries' products in general. They are also able to educate their members regarding new developments and techniques which are available to the trade.

In neither case are the exempt organizations exploiting their exempt status in order to compete unfairly with taxpaying organizations. Generally, horse racing dates are controlled by State authorities and are made available on a State-wide basis to only one organization for any one period. Trade shows are generally conducted only by trade associations and not by taxpaying entities.

Explanation of provision

In the case of fairs and expositions, the Act exempts from the unrelated business income tax the income derived from a qualified public entertainment activity by an organization which is exempt under section 501(c) (3), (4), or (5) of the Code (charitable, social welfare, or agricultural) if the organization's activity meets one of the following conditions:

(1) the public entertainment activity is conducted in conjunction with a public international, national, State, regional, or local fair or exposition;

(2) the activity is conducted in accordance with State law which permits that activity to be conducted only by that type of exempt organization or by a governmental entity; or

(3) the activity is conducted in accordance with State law which allows that activity to be conducted for not more than 20 days in any year and which permits the organization to pay a lower percentage of the revenue from this activity than the State requires from other organizations.

In order to qualify for this treatment, the organization must regularly conduct, as one of its substantial exempt purposes, a fair or exposition which is both agricultural and educational. Thus, a book fair held by a university does not come within this provision since such a fair is not an agricultural fair or exposition.

The conducting of qualified public entertainment activities is not to affect the tax-exempt status of the organization.

In the case of conventions and trade shows the Act exempts from the unrelated business income tax the income derived from a qualified convention and trade show activity by an organization which is exempt under section 501(c) (5) or (6) of the Code (generally, unions or trade associations) and which regularly conducts as one of its exempt purposes a convention or trade show activity which stimulates interest in, and demand for an industry's products in general. In order to constitute a qualifying convention and trade show activity all the following conditions must be met:

First, it must be conducted in conjunction with an international, national, State, regional, or local convention, annual meeting, or show;

Second, one of the purposes of the organization in sponsoring that activity must be the promotion and stimulation of interest in, and demand for, the industry's products and services in general; and

Third, the show must promote that purpose through the character of the exhibits and the extent of the industry products displayed.

Effective dates

This provision applies to taxable years beginning after December 31, 1962, with respect to qualified public entertainment activities, and to taxable years beginning after the date of enactment (October 4, 1976), with respect to qualified convention and trade show activities.

Revenue effect

It is estimated that the revenue impact of these provisions will be relatively small.

6. Declaratory Judgments as to Tax-Exempt Status as Charitable, etc., Organization (sec. 1306 of the Act and new sec. 7428 of the Code)

Prior law

An organization that meets the requirements of section 501(c)(3) of the Code [1] is exempt from tax on its income.[2]

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[1] "SEC. 501 EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

"(a) Exemption From Taxation.—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

* * * * * * *

"(c) List of Exempt Organizations.—The following organizations are referred to in subsection (a):

* * * * * * *

"(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, *or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment)*, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (*except as otherwise provided in subsection (h)*), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." (The first italicized item was added by section 1313 of the Act, described below, under 13. Exemption of Certain Amateur Athletic Organizations From Tax; the second italicized item was added by section 1307 of the Act, described below, under 7. Lobbying Activities of Public Charities.)

[2] Such an organization is, nevertheless, subject to tax on its "unrelated business taxable income" (sec. 511 *et seq.*) and, if it is a private foundation, is also subject to tax on its "net investment income" (sec. 4940 or 4948); however, it is not subject to Federal income tax on its related business income. The tax on private foundations' investment income is at the rate of 4 percent; by comparison, the rates applicable to taxable corporations are up to 48 percent, and to taxable trusts are up to 70 percent.

In general, a domestic organization which is exempt under section 501(c)(3) is also eligible to receive deductible charitable contributions (sec. 170(c)(2)).

If such an organization is a private foundation (defined in sec. 509), then it is subject to a series of restrictions on its activities (sec. 4941 *et seq.*), as well as a tax on its investment income (see footnote 2 above). Also, if it is classified as a private foundation (other than an operating foundation (sec. 4942(j)(3)), its status as a charitable contribution donee is in some respects significantly less favorable than if it is not so classified (compare sec. 509(a) with sec. 170(b)(1)).

Although the tax status of an organization generally has not depended on the Internal Revenue Service's position as to the organization, as a practical matter, most organizations hoping to qualify for exempt status found it imperative to obtain a favorable ruling letter from the Service and to be listed in the Service's "blue book" (Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1954, Publication 78). An exemption letter and listing in the blue book assured potential donors in advance that contributions to the organization would qualify as charitable deductions under section 170(c)(2). In general, potential donors could rely upon these indicia even though the organization might not in fact be qualified under the statute for this treatment at the time of the gift.[3]

In two cases decided in 1974 (*Bob Jones University* v. *Simon*, 416 U.S. 725, and *Alexander* v. *"Americans United" Inc.*, 416 U.S. 752), the Supreme Court held that an organization could not obtain the assistance of the courts to restrain the Internal Revenue Service from withdrawing a favorable ruling letter or withdrawing its listing in the blue book. In effect, this meant that a judicial determination as to the organization's status could not be obtained by the organization or its contributors, except in the context of a suit to redetermine a tax deficiency or to determine eligibility for a refund of taxes.

By the time the Supreme Court issued its opinions in *Bob Jones* and *Americans United*, both Houses of Congress had already passed versions of what became the Employee Retirement Income Security Act of 1974 (Public Law 93-406). Each House's version of that bill included provisions for declaratory judgments as to the tax-qualified status of employee retirement plans. This ultimately became section 1041 of that Act, which added section 7476 to the Internal Revenue Code.

Under that provision, the Tax Court has been given jurisdiction to hear declaratory judgment suits as to the tax qualifications of an employee retirement plan (pension, profit sharing, stock bonus, etc.), so that the plan's status can be tested without the necessity of the Service issuing a notice of deficiency or a taxpayer suing for a refund of taxes.

Reasons for change

In *Bob Jones University* v. *Simon*, the Supreme Court summarized the problems faced by an organization seeking to establish its charitable tax-exempt status. The Court noted that, as it interpreted present law,

"Congress has imposed an especially harsh regime on § 501(c)(3) organizations threatened with loss of tax-exempt status and

[3] See Rev. Proc. 1972-39, 1972-2 CB 818, for the Service's position on the extent to which contributors may rely on the listing of an organization in the blue book.

with withdrawal of advance assurance of deductibility of contribution. * * * The degree of bureaucratic control that, practically speaking, has been placed in the Service over those in petitioner's position [i.e., the position of Bob Jones University] is susceptible to abuse, regardless of how conscientiously the Service may attempt to carry out its responsibilities. Specific treatment of not-for-profit organizations to allow them to seek preenforcement review may well merit consideration." [4]

The opinion then suggested that this was an appropriate matter for the Congress to consider.[5]

In order to provide an effective appeal from an Internal Revenue Service determination that an organization was not exempt from tax, or was not an eligible donee for charitable contributions, or was a private foundation (an operating foundation or a nonoperating foundation), it was urged that there be access to the courts through some declaratory judgment procedure.

The same line of reasoning outlined by the Supreme Court in those two cases, and which motivated the Congress to act with regard to employee retirement plans, applies in this case. Accordingly, the Congress agreed to provide in this Act for a declaratory judgment procedure under which an organization can obtain a judicial determination of its own status [6] as a charitable, etc., organization, its status as an eligible charitable contributions donee, its status as a private foundation, or its status as a private operating foundation. Also, the Act provides assurances regarding contributions made during the litigation period.

In connection with this, and as an aid to proper oversight and to future decision-making in this area, the Congress intends that the Internal Revenue Service report annually to the tax-writing committees of the Congress on the Service's activities with regard to organizations exempt under section 501(a), including the following: (1)

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[4] The Court's opinion noted that former Internal Revenue Commissioner Thrower had criticized the then-existing system for resolving such disputes between the Service and the organization.

"This is an extremely unfortunate situation for several reasons. First, it offends my sense of justice for undue delay to be imposed on one who needs a prompt decision. Second, in practical effect it gives a greater finality to IRS decisions than we would want or Congress intended. Third, it inhibits the growth of a body of case law interpretative of the exempt organization provisions that could guide the IRS in its further deliberations." (Thrower, IRS Is Considering Far Reaching Changes in Ruling on Exempt Organizations, 34 Journal of Taxation 168 (1971).)

[5] In a dissenting opinion to *Alexander* v. *"Americans United", Inc.*, the companion case to *Bob Jones University* v. *Simon,* Mr. Justice Blackmun stated that, "where the philanthropic organization is concerned, there appears to be little to circumscribe the almost unfettered power of the Commissioner." This may be very well so long as one subscribes to the particular brand of social policy the Commissioner happens to be advocating at the time (a social policy the merits of which I make no attempt to evaluate), but applications of our tax laws should not operate in so fickle a fashion. Surely, social policy in the first instance is a matter for legislative concern. To the extent these determinations are reposed in the authority of the Internal Revenue Service, they should have the system of checks and balances provided by judicial review *before* an organization that for years has been favored with an exemption ruling is imperiled by an allegedly unconstitutional change of direction on the part of the Service." (Footnote omitted.)

[6] The Supreme Court has implicitly held that under certain circumstances suits can be brought by third parties to restrain the Internal Revenue Service from treating an organization as being exempt, *Coit* v. *Green,* 404 U.S. 997 (1971), affirming *Green* v. *Connally,* 330 F. Supp. (D.C., D.C., 1971), a decision by a special 3-judge district court. The Act does not deal with this matter. This Act constitutes neither an implied endorsement nor an implied criticism of such "third-party" suits. However, the Congress does intend that, with respect to accepting *amicus curiae* briefs and permitting appearances by third parties in declaratory judgment suits under this Act, the courts should be as generous as they can be, in the light of the need for expeditious decisions in those cases and the general state of the courts' calendars.

the number of organizations that applied for recognition of exempt status, (2) the number of organizations whose applications were accepted and the number of organizations whose applications were denied, (3) the number of organizations whose prior favorable ruling letters were revoked, (4) the number of organizations that were audited during the year, and (5) the number of organizations that the Service regards as being exempt. To the extent possible, these statistics should be broken out by type of organization (e.g., public charity, private foundation, social welfare organization, fraternal beneficial association, and veterans organization). In addition, the Service should report the amount of its expenditures for the year, the amount of its requested appropriations for the following 2 years, the amount appropriated for each of the years, and the amounts authorized to be appropriated under the terms of section 1052 of the Employee Retirement Income Security Act of 1974.

Explanation of provision

In general.—The Act provides that the Federal district court for the District of Columbia, the United States Court of Claims, and the United States Tax Court are to have jurisdiction in the case of an actual controversy involving a determination (or failure to make a determination) by the Internal Revenue Service with respect to the initial or continuing qualification or classification of an organization as an exempt charitable, etc., organization (sec. 501(c)(3)), as a qualified charitable contribution donee (sec. 170(c)(2)), as a private foundation (sec. 509, or as a private operating foundation (sec. 4942 (j)(3)). A suit under this provision can be brought only by the organization whose qualification or status is at issue.

The courts have jurisdiction to make a declaration with respect to the status of the organization and any such declaration is to have the force and effect of a decision or final judgment and is to be reviewable as such.

The court is to base its determination upon the reasons provided by the Internal Revenue Service in its notice to the party making the request for a determination, or based upon any new argument which the Service may wish to introduce at the time of the trial. The burden-of-proof rules are to be developed by the courts under their rule-making powers. Insofar as is practical, those rules should conform to the rules that the Tax Court develops with regard to declaratory judgment suits as to retirement plans, under section 7476 of the Code. (See *e.g.*, title XXI of the Tax Court's Rules of Practice and Procedure.)

The judgment of the court in a declaratory judgment proceeding shall be binding upon the parties to the case based upon the facts as presented to the court [7] in the case for the year or years involved. This, of course, does not foreclose Service action for later years (within the limits of the legal doctrines of estoppel and *stare decisis*) if the governing law or the organization's operations have changed since the years to which the declaratory judgment applies, or (especially in the case of a new organization) if the organization does not in operation meet the requirements for qualification.

[7] In many cases, this would be essentially the administrative record before the Internal Revenue Service; see, e.g., paragraphs (5) and (6) of the prefatory note to title XXI of the Tax Court's Rules of Practice and Procedure.

This provision is intended to facilitate relatively prompt judicial review of the specified types of exempt organization issues; it is not intended to supplant the normal avenues of judicial review (redetermination of a deficiency or suit for refund of taxes) where those normal procedures could be expected to provide opportunities for prompt determinations. Consequently, it is expected that the courts will not entertain a declaratory judgment suit with regard to a period for which a notice of deficiency has already been issued, except upon a showing by the organization that the declaratory judgment route is likely to substantially reduce the time necessary to attain a final judicial review of the Service's determination. Also, it is expected that in general a court which has accepted pleadings in a declaratory judgment proceeding will yield to a court which has accepted pleadings in a redetermination of deficiency or a tax refund suit, unless the proceedings in the declaratory judgment suit are so far along that it would facilitate the interest of prompt justice for the latter court to yield to the former. The Congress' action is not to be permitted to create conflicting determinations on the parts of different trial courts with regard to any of the questions that may be determined in a declaratory judgment suit; nor is the Congress' action to operate so as to require duplication of effort on the part of parties, witnesses, or courts.

Contributions made during the litigation period.—As is the case regarding retirement plans (under sec. 7476) the courts have jurisdiction to determine whether the Service has correctly concluded that a previously exempt organization has lost its charitable donee status because of changes in operation, changes in the governing law, changes in the governing instrument, etc.[8] In order to reduce the likelihood of the litigation "drying up" the resources of an organization's support (especially if that organization depends primarily on current contributions from the general public), the Act provides that, under specified circumstances, contributions made during the litigation period may be deductible even though the court ultimately determines that the organization had lost its status as an eligible charitable donee under section 170(c)(2) of the Code.

This protection applies only where the organization had previously been declared to be an eligible donee, the Service has published a notice of the revocation of its advance assurance of deductibility of contributions, and the organization has initiated its proceeding before the 91st day after the Service mailed its adverse determination to the organization. The "publication" requirement is satisfied if the Internal Revenue Service has made a public announcement, such as by issuing a press release or by printing the notice in the Internal Revenue Bulletin.

[8] A recent United States Tax Court decision (*Sheppard & Myers, Inc.*, 67 T.C. No. 3 (October 6, 1976)) held that the retirement plans declaratory judgment provisions do not apply to revocations of favorable determination letters. The statutory language ("In a case of actual controversy involving—(1) a determination by the Secretary * * * with respect to the initial qualification *or continuing qualification* * * *" (emphasis supplied)) of the employee plans declaratory judgment provision (sec. 7476(a)) is in this respect the same as the statutory language of the exempt organizations declaratory judgment provisions (sec. 7428(a)) added by this Act. That court's opinion, although issued after enactment of the 1976 Act, omits mention of this Act; it also makes no mention of the statements in both the House and Senate reports on this Act that this statutory language, in both Acts, is intended to grant jurisdiction in cases where the Internal Revenue Service has concluded that a previously qualified organization has lost its preferred tax status.

Sometimes, the first notice to the public consists of a notice of suspension of advance assurance of deductibility of contributions to the organization. (See sec. 4 of Rev. Proc. 72–39, 1972–2 CB 818.) In terms of its effect on potential contributors, such a notice is the functional equivalent of a notice of revocation. That is, potential contributors will be reluctant to make contributions to the organization once notice of such a suspension is published. Consequently, for purposes of the provision protecting contributions made during the litigation period, a notice of suspension of advance assurance is to be treated the same as a notice of revocation of advance assurance of deductibility.

If these criteria are met, then contributions made by an individual or by an organization described in section 170(c)(2) which is exempt from tax under section 501(a) to or on behalf of the organization in the period beginning on the date of publication of the notice of revocation and ending on the date on which the court has first determined that the organization is not an eligible donee under section 170(c)(2) are to be treated as having been made to or on behalf of an organization described in section 170(c)(2), for purposes of determining the income tax charitable contribution deduction of the contributor. However, the aggregate of deductions by any individual contributor to be given this protection with regard to contributions to or on behalf of any one organization may not exceed $1,000 for the entire period.[9] (For these purposes, a husband and wife are treated as one contributor.) This benefit does not apply to any individual who was responsible, in whole or in part, for the actions (or failures to act) on the part of the organization which were the basis for the revocation.

From time to time, the Internal Revenue Service, in announcing its revocation of assurance as to exempt status, has applied this revocation retroactively, to the date of the asserted improper actions or failures to act (sec. 7805(b)). The Congress understands that in such cases the retroactive revocation was not applied to those contributors who were innocent of the improper actions or failures to act. The Congress intends that the Service continue to follow this course, which is consistent with the rule provided in this Act.

Exhaustion of administrative remedies required.—For an organization to receive a declaratory judgment under this provision, it must demonstrate to the court that it has exhausted all administrative remedies which are available to it within the Internal Revenue Service. Thus, it must demonstrate that it has made a request to the Internal Revenue Service for a determination and that the Internal Revenue Service has either failed to act, or has acted adversely to it, and that it has appealed any adverse determination by a district office to the national office of the Internal Revenue Service or has requested or obtained through the district director technical advice of the national office. To exhaust its administrative remedies, the organization must satisfy all appropriate procedural requirements of the Service. For example, the Service may decline to make a determination if the organization fails to comply with a reasonable request by the Service to supply the necessary information on which to make a determination.

[9] Of course, this $1,000 "cap" is not to restrict deductibility if the final decision or judgment is in favor of the charitable, etc., organization.

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An organization is not to be deemed to have exhausted its administrative remedies in a case where there is a failure by the Internal Revenue Service to make a determination, before the expiration of 270 days after the request for such a determination has been made. Once this 270-day period has elapsed, an organization which has taken all reasonable steps to secure a determination may bring an action even though there has been no notice of determination from the Internal Revenue Service.

Of course, if the Service makes a determination during this 270-day period, then the organization need not wait until the end of the 270-day period to initiate the declaratory judgment proceeding. However, no petition under this provision may be filed more than 90 days after the date on which the Service sends notice to the organization of its determination (including refusals to make determinations) as to the status of the organization.

Tax Court commissioners.—In order to provide the Tax Court with flexibility in carrying out this provision, the Act authorizes the Chief Judge of the Tax Court to assign the commissioners ("special trial judges") of the Tax Court to hear and make determinations with respect to petitions for a declaratory judgment, subject to such conditions and review as the Court may provide. It is anticipated, for example, that the court may initially provide that all the declaratory judgment cases are to be heard by judges, rather than commissioners. However, if the volume of these cases is large, then the Tax Court may expedite the resolution of these cases by authorizing its commissioners to hear and enter decisions in cases where similar issues have already been heard and decided by the judges of the Court. However, as is the case with regard to Tax Court declaratory judgments in employee retirement plan cases, this example is not intended to be a restriction on the Tax Court's authority with regard to the use of these commissioners in declaratory judgment cases. The flexibility is granted to the Court to assign its commissioners to hear and decide these cases in such a manner as the Court may deem appropriate.

Effective date

These provisions are to apply to pleadings filed with the Federal district court for the District of Columbia, the United States Court of Claims, or the United States Tax Court more than 6 months after the date of enactment, but only with respect to Service determination (or requests by the organizations for Service determinations) made after January 1, 1976.

These effective date provisions have been chosen basically for two purposes: (1) to provide the courts an opportunity to establish any necessary rules and otherwise make administrative preparations for initiation of these new declaratory judgment proceedings, and (2) to assure that "stale" cases are not made the subject of court suits without the organization first giving the Internal Revenue Service an opportunity to reexamine the case. It is not the intention of the Congress that the Service be permitted to cut off an organization's declaratory judgment suit rights by sending the organization its unfavorable determination more than 90 days before this provision would otherwise become effective. It is intended, in such a case, that the Service send another determination to the organization at such a time that the organization would have an opportunity to initiate a court proceeding for a declaratory judgment. For example, if the Service sent an organization an unfavorable determination in July 1976, the Service should send that organization another determination in, for example, April 1977. The April notification is to start the running of the 90-day period for initiating court proceedings. The July notification is to start the litigation period, during which deductibility of contributions is to be protected.

Revenue effect

These provisions are not expected to have any revenue effect.

7. Lobbying Activities of Public Charities (sec. 1307 of the Act and secs. 501 and 4911 of the Code)

Prior law

Prior law (sec. 501(c)(3) of the Internal Revenue Code of 1954) imposed upon every organization qualifying for tax-exempt status as an educational, charitable, religious, etc., organization the require ment that "no substantial part of the activities of [the organization] is carrying on propaganda, or otherwise attempting, to influence legislation". This requirement was also a precondition of such an organization's qualification to receive charitable contributions that are deductible for income, estate, or gift tax purposes (secs. 170(c), 2055(a), 2106(a), 2522(a), and 2522(b)).

Reasons for change

The language of the lobbying provision was first enacted in 1934. Since that time neither Treasury regulations nor court decisions gave enough detailed meaning to the statutory language to permit most charitable organizations to know approximately where the limits were between what was permitted by the statute and what was forbidden by it. This vagueness was, in large part, a function of the uncertainty in the meaning of the terms "substantial part" and "activities".

Many believed that the standards as to the permissible level of activities under prior law were too vague and thereby tended to encourage subjective and selective enforcement.

Except in the case of private foundations, the only sanctions available under prior law with respect to an organization which exceeded the limits on permitted lobbying were loss of exempt status under section 501(c)(3) and loss of qualification to receive deductible charitable contributions. Some organizations (particularly organizations which had already built up substantial endowments) could split up their activities between a lobbying organization and a charitable organization. For such organizations, these sanctions may have had little effect, and this lack of effect may have tended to discourage enforcement effort.[1]

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[1] The Treasury Department's regulations (Regs. § 1.501(c)(3)-1(c)(3)(v)) specifically provided that an organization that lost its exempt status under section 501(c)(3) because of excessive lobbying could become exempt on its own income under section 501(c)(4) as a "social welfare" organization. Also, a number of organizations that in this manner shifted to section 501(c)(4) had created related organizations to carry on their charitable activities, to qualify for exemption under 501(c)(3), and to qualify to receive deductible charitable contributions. If the original organization had built up a substantial endowment during its years of section 501(c)(3) status, it could then carry on its "excessive" lobbying activities financed by the income it received from its tax-deductible endowment. As a result, although there may have been some inconvenience and administrative confusion during the changeover period, it was possible in such a case for the lobbying rules to be violated without any significant tax consequences.

For other organizations which could not split up their activities between a lobbying organization and a charitable organization and which had to continue to rely upon the receipt of deductible contributions to carry on their exempt purposes, loss of section 501(c)(3) status could not be so easily compensated for and constituted a severe blow to the organization.

The Act is designed to set relatively specific expenditure limits to replace the uncertain standards of prior law, to provide a more rational relationship between the sanctions and the violations of standards, and to make it more practical to properly enforce the law. However, these new rules replace prior law only as to charitable organizations which elect to come under the standards of the Act. The new rules also do not apply to churches and organizations affiliated with churches, nor do they apply to private foundations; prior law continues to apply to these organizations. The Act provides for a tax of 25 percent of the amount by which the expenditures exceed the permissible level. Revocation of exemption is reserved for those cases where the excess is unreasonably great over a period of time.

Explanation of provision

The Act permits public charitable tax-exempt organizations to elect to replace the "substantial part of activities" test with a limit defined in terms of expenditures for influencing legislation. The basic permitted level of such expenditures ("lobbying nontaxable amount") for a year is 20 percent of the first $500,000 of the organization's exempt purpose expenditures for the year, plus 15 percent of the second $500,000, plus 10 percent of the third $500,000, plus 5 percent of any additional expenditures. However, in no event is this permitted level to exceed a "cap" of $1,000,000 for any one year.

Within those limits, a separate limitation is placed on so-called "grass roots lobbying"—that is, attempts to influence the general public on legislative matters. This grass roots nontaxable amount is one-fourth of the lobbying nontaxable amount.

Sanctions.—An electing organization that exceeds either the general limitation or the grass roots limitation in a taxable year is to be subject to an excise tax of 25 percent of its excess lobbying expenditures. Furthermore, if an electing organization's lobbying expenditures normally (that is, on the average over a four-year period) exceed 150 percent of the limitations describe above,[2] the organization is to lose its exempt status under section 501(c)(3).[3]

If, for a taxable year, the organization's expenditures exceed both the nontaxable lobbying amount and the nontaxable grass roots amount, then the 25-percent tax is to be imposed on whichever one of these excesses is the greater.

These sanctions are to operate automatically. That is, if an organization exceeds the permitted lobbying amounts, then it is subject to the excise tax and may also be subject to the loss of exempt status.

[2] An organization's lobbying expenditures "normally" exceed 150 percent of the permitted amount if (1) the sum of its lobbying expenditures (or grass roots expenditures) for the 4 years immediately preceding the current year is greater than (2) 150 percent of the sum of the "lobbying nontaxable amounts" (or grass roots nontaxable amounts) for those same 4 years.

[3] As is further described below, in such a case the organization is not to be permitted to "shift" to section 501(c)(4) status.

Imposition of these sanctions (or, in the case of loss of exemption, the effective date of the sanction) is not to depend on the exercise of discretion by the Internal Revenue Service. However, imposition of these sanctions on the organization is not intended to preclude the Service from continuing its present practice of generally disallowing deductions of contributions to an organization only where the contributions are made on or after the date that the Service announces the organization is no longer exempt (see discussion of this point above, under 6. Declaratory Judgments as to Tax-Exempt Status as Charitable, etc., Organization).

As in the case of the chapter 42 (private foundation) and chapter 43 (qualified pension, etc., plans) taxes, in order to assess a deficiency of the excise tax imposed under these new provisions on excess lobbying expenditures, the Internal Revenue Service must send a notice of deficiency to the exempt organization. The exempt organization can obtain judicial review, without first paying the tax, by petitioning the Tax Court for a redetermination of the deficiency. Alternatively, the organization can pay the tax, file a claim for refund, and then sue for a refund in the Court of Claims or a Federal district court.

The Act also makes it clear that this excise tax, like the excise taxes imposed with respect to private foundations and qualified pensions, etc., plans, is in no event to be deductible.

Influencing legislation.—For purposes of these new rules, the Act defines the term "influencing legislation" as any attempt to influence any legislation through an attempt to affect the opinion of the general public or any segment thereof ("grass roots lobbying") and any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any other government official or employee who may participate in the formulation of the legislation ("direct lobbying").

Generally, the term "legislation" includes action with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure.[4] The term "action" is limited to the introduction, amendment, enactment, defeat, or repeal of Acts, bills, resolutions, or similar items.

The Act excludes from "influencing legislation" three categories of activities which the Congress also excluded from that concept under the private foundation provisions (sec. 4945(e)). These are (1) making available the result of nonpartisan analysis, study, or research; (2) providing technical advice or assistance in response to a request by a governmental body; and (3) so-called self-defense direct lobbying—that is, appearances before or communications to a legislative body with respect to a possible decision of that body which might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deduction of contributions to the organization.[5]

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[4] As the Internal Revenue Service has noted (Rev. Rul. 73–440, 1973–2 CB 177), the prohibition on substantial lobbying activities includes attempts to influence legislation of a foreign country.

[5] The Internal Revenue Service had ruled that the first of these categories of activities did not affect the exempt charitable status of an organization (Rev. Rul. 64–195, 1964–2 CB 138) under prior law. The second of these categories had also been specifically ruled by the Internal Revenue Service as not constituting "influencing legislation" in the case of public charities (Rev. Rul. 70–449, 1970–2 CB 111).

In addition, the Act excludes communications between the organization and its bona fide members unless the communications directly encourage the members to influence legislation or directly encourage the members to urge nonmembers to influence legislation. For example, where a publication is designed primarily for members but an insubstantial portion of the distribution is to nonmembers and an insubstantial portion of the material in the publication is devoted to legislative issues, the discussion of such legislative issues is to be considered as a communication with bona fide members, not a communication with other persons.[6]

In general, to be a "bona fide member," a person must have more than a nominal connection with the organization. The person should have affirmatively expressed a desire to be a member. In addition, the person must, in the usual case, also fall in one of the following classes:

(1) pay dues of more than a nominal amount;

(2) make a contribution of more than a nominal amount of time to the organization; or

(3) be one of a limited number of "Honorary" or "Life" members chosen for a valid reason.

It is not intended that these rules be exclusive, and an organization with membership rules that do not fall within any of these categories may still be able to treat its members as "bona fide members" if it can demonstrate to the Internal Revenue Service that there was a good reason for its membership requirements not meeting these standards and that these membership requirements do not serve as a subterfuge for grass roots lobbying activities.

Under the Act, a communication between an electing organization and any bona fide member of the organization to directly encourage that member to engage in direct lobbying is to be treated as direct lobbying. If the communication is to directly encourage the member to urge nonmembers to engage in direct lobbying or grass roots lobbying, then it is to be treated as the organization engaging in grass roots lobbying.

Under the Act, if an organization communicates with a member or employee of a legislative body and one of the purposes is influencing legislation, then the appropriate portion of the costs of that effort are to be treated as lobbying expenditures. If the communication is with a government official or employee who is not a member of or employed by a legislative body, then the costs of the communication are to be taken into account only if the principal purpose of the communication is to influence legislation.

Exempt purpose expenditures.—As indicated above, the determination of whether an electing organization is subject to the excise tax established by the Act is to be made by comparing the amount of the lobbying expenditures with the organization's "exempt purpose ex-

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[6] An allocable portion of the cost of a publication which is designed primarily for members and which includes some material directly encouraging the members to engage in direct lobbying is to be treated as an expenditure for direct lobbying. However, the fact that some copies of the publication are distributed to libraries and other bona fide subscribers will not cause any portion of those expenditures to be treated as expenditures for grass roots lobbying. On the other hand, if more than 15 percent of the copies of the publication are distributed to nonmembers (including libraries), the portion of the cost of the publication allocable to the lobbying material is to be allocated between the activities relating to members and the activities relating to nonmembers (grass roots lobbying) in proportion to the distribution of the publication.

penditures" for the taxable year. The term "exempt purpose expenditures" includes the total of the amounts paid or incurred by the organization for exempt religious, charitable, educational, etc., purposes.

In computing exempt purpose expenditures, amounts properly chargeable to capital account are to be capitalized. However, when the capital item is depreciable, then a reasonable allowance for depreciation, computed on a straight-line basis, is to be treated as an exempt purpose expenditure.

For purposes of these provisions, the term "exempt purpose expenditure" also includes administrative expenses paid or incurred with respect to any charitable, etc., purpose: it also includes all amounts paid or incurred the purpose of influencing legislation, whether or not for exempt purposes.[7]

Exempt purpose expenditures do not include amounts paid or incurred to or for a separate fund-raising unit of an organization (or an affiliated organization's fund-raising unit); they also do not include amounts paid or incurred to or for any other organization, if those amounts are pair or incurred primarily for fund raising.

Affiliation rules.—In order to forestall the creation of numerous organizations to avoid the effects of the decreasing percentage test used to compute the lobbying and grass roots nontaxable amounts, or efforts to avoid the $1,000,000 "cap" on lobbying expenditures, the act provides a method of aggregating the expenditures of related organizations.

If two or more organizations are members of an affiliated group, and at least one organization in that group has elected to come under the new rules of the Act then the calculations of lobbying expenditures and exempt purpose expenditures are to be made by taking into account the expenditures of the entire group. If the expenditures of the group as a whole do not exceed the permitted limits, then the members of the group that elected the new standards are treated as not exceeding the permitted limits. On the other hand, if the expenditures of the group as a whole do exceed the permitted limits, then each of the organizations that elected to have the new rules apply is treated as having exceeded the permitted limits. Each of those electing organizations is to pay the tax on its proportionate share of the group's excess lobbying expenditures.

Only those members of the affiliated group that have elected are to be subject to this tax. The nonelecting members of the group are to remain under prior law with regard to their expenditures and other activities.

Generally, two organizations are affiliated if (1) one organization is bound by decisions of the other organization on legislative issues, or (2) the governing board of one organization includes enough representatives of the other organization to cause or prevent action on legislative issues by the first organization. Where organizations are

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[7] This Act deals only with whether an organization is to be treated as violating the lobbying limits of the law. The Act does not affect the question of whether an expenditure might cause the organization to lose its charitable status because the expenditure violates the requirement that the organization be organized and operated "exclusively" for charitable, etc., purposes. (The Supreme Court has defined "exclusively" in this context to mean that there is no nonexempt purpose that is "substantial in nature." *Better Business Bureau* v. *U.S.*, 326 U.S. 279, 283 (1945).) Also, the Act does not deal with the circumstances under which an expenditure might be treated as electioneering, which constitutes another cause for loss of exempt status.

affiliated, as described above, in a chain or similar fashion, all organizations in the chain are to be treated as one group of affiliated organizations. Thus, for instance, if organization Y is bound by the decisions of organization X on legislative issues and organization Z is bound by the decisions of organization Y on such issues, then X, Y, and Z are all members of one affiliated group of organizations. However, if a group of autonomous organizations control another organization but no one organization in the controlling group can, by itself, control the actions of the potentially controlled organization, the organizations are not treated as an affiliated group by reason of the "interlocking directorates" rule.

There is affiliation if either of the two conditions is satisfied; that is, if there is either control through the operation of the governing instrument or voting control through "interlocking directorates." In general, any degree of control by operation of governing instruments is enough to satisfy this affiliation test. The existence of the power is sufficient, whether or not the "controlling" organization is exercising the power. However, where the affiliation in the group exists solely because of the control provisions of governing instruments (i.e., there are no interlocking directorates) and where those control provisions operate only with respect to national legislation, then the expenditure standards are to be applied in the following manner:

(1) The controlling organization is to be charged with all of its lobbying expenditures and also with the national legislation lobbying expenditures of all of the other affiliated organizations. The controlling organization is not to be charged with any other lobbying expenditures (or other exempt purpose expenditures) made by the other organizations with respect to issues other than national legislation issues.

(2) Each local organization is to be treated as though it were not a member of an affiliated group; that is, the local organization is to take account of its own expenditures only.

For these purposes, an issue that has both national and local ramifications is to be categorized on the basis of whether or not the contemplated legislation is Congressional legislation. For example, lobbying with respect to a U.S. constitutional amendment is to be treated as Congressional lobbying up to the time the proposed amendment is approved by the Congress. Lobbying campaigns with respect to State ratification are to be treated as lobbying with respect to State legislatures.

The "interlocking directorates" rule is to be applied by taking into account whether the governing board of the potentially controlled organization includes enough representatives of the controlling organization so as to cause or prevent action on legislative issues by the controlled organization. The representatives are to include persons who are specifically designated representatives of the controlled organization, members of the governing board of the controlling organization, officers of the controlling organization, and paid executive staff members of the controlling organization. Although titles are significant in determining whether a person is a member of the "executive staff" of an organization, in general the test will be the extent to which the employee exercises executive-type powers in that organization.

Where there is an affiliated group, a number of the provisions discussed above are to be applied as though the affiliated group constitutes one organization. In the case of the "self-defense" exclusion from the definition of influencing legislation, for example, the effort by a national organization to deal with matters which might affect the existence of the local members of its affiliated group are to be treated as self-defense expenditures by the national organization. Similarly, communications by the national organization to members of the local organizations in its affiliated group are to be treated the same as communications by the national organization to its own members. Also, where the national organization pays or incurs expenditures for fund-raising by its local affiliates, these expenditures are to be treated as though they had been paid or incurred for the national organization's fund-raising purposes.

Because the question of whether an affiliated group exists may be critical in determining whether an organization has violated the standards under the Act, the Congress intends that the Internal Revenue Service make provision for issuing opinion letters at the request of electing organizations to determine whether those organizations are members of affiliated groups and to determine which other organizations are members of such groups. Of course, if conditions change materially, then the conclusion stated in any such opinion letter would not bind the Service. However, a willingness by the Service to rule on such questions would go far to further reduce the uncertainty that has prevailed in this part of the law.

Disallowance of deduction for out-of-pocket expenses to influence legislation.—Under present law, a deduction is available for certain out-of-pocket expenditures incurred by a person on behalf of a charitable organization. Since, for purposes of the new expenditures test, it is necessary to have relevant expenditures appear in the books and records of the organization, an expenditure test could readily be evaded if the lobbying could be conducted on behalf of the organization by individuals with deductible out-of-pocket contributions. Accordingly, the Act provides that a person may not deduct an out-of-pocket expenditure on behalf of a charitable organization if the expenditure is made for the purpose of influencing legislation and if the organization is eligible to elect the expenditures test provided by the Act.[8]

Status of organization after loss of charitable status.—Under prior law, an organization which lost its exempt status under section 501(c)(3) generally could nevertheless remain exempt on its own income (although generally ineligible to receive deductible charitable contributions) as a "social welfare" organization under section 501(c)(4). The availability of this continued exemption permitted an organization to build up an endowment out of deductible contributions as a charitable organization and then use that tax-favored fund to support substantial amounts of lobbying as a section 501(c)(4) social welfare organization.[9]

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[8] Treasury Regulations § 1.170A-1(h)(6) provide that "No deduction shall be allowed under section 170 for expenditures for lobbying purposes, promotion or defeat of legislation, etc." However, it is not clear that this provision of the Regulations has been applied to disallow deductions for such expenditures.

[9] State law would in the usual case require the funds originally dedicated to charitable purposes to remain so dedicated, even though the organization may have lost its Internal Revenue Code charitable status. However, it is not clear whether State law would prevent such an organization from carrying on substantial lobbying activities.

In order to stop such a transfer of charitable endowment, the Act provides that an organization which is eligible to elect under the expenditures test provided by the Act cannot become a social welfare organization exempt under section 501(c)(4) if it has lost its status as a charity because of excessive lobbying. The Act also gives the Treasury Department the authority to prescribe regulations to prevent avoidance of this rule (for example, by direct or indirect transfers of all or part of the assets of an organization to an organization controlled by the same person or persons who control the transferor organization).

This new provision does not apply to churches (or organizations related to churches), which are ineligible to make an election of the new rules relating to lobbying (see discussion below, under *Eligible organizations*).

This rule forbidding an organization that loses its charitable, etc., status to become a tax-exempt social welfare organization applies only if the loss of charitable, etc., status is because of excessive lobbying. As under present law, such an organization could ultimately reestablish its status as a charitable organization. (See, for example, *John Danz Charitable Trust*, 32 T.C. 469 (1969), *aff'd.*, 284 F.2d 726 (C.A. 9, 1960).) However, the organization could never establish exempt status under section 501(c)(4).

This rule applies only in the case of organizations that have lost their charitable, etc., status as a result of activities occurring after the date of enactment (October 4, 1976).

Disclosure of lobbying expenditures.—Prior law (sec. 6033(b)) has required most charitable, etc., organizations (with specific exemptions made for churches and certain other organizations) to include on their information returns certain specified categories of information related generally to types of expenditures made by the organization. Another provision of prior law (sec. 6104(b)) has provided that the information required to be furnished on those information returns was to be made available to the public.

In order to permit the public to obtain information as to lobbying expenditures by organizations that have elected to come under the standards of the Act, section 6033 is amended to specifically require that any organization that has elected under these rules must disclose on its information return the amount of its lobbying expenditures (total and grass roots), together with the amount that it could have spent for these purposes without being subject to new excise tax provided by the Act. If an electing organization is a member of an affiliated group, then it must provide this information with respect to the entire group, as well as with respect to itself.

This Act is not intended to restrict any authority that the Treasury Department may have had under prior law to require exempt organizations to provide information for the purpose of carrying out the internal revenue laws.

In addition, the Act requires the Internal Revenue Service to notify the appropriate State officer of the mailing of a notice of deficiency of the tax imposed on excess lobbying expenditures. The appropriate State officer is the State offical charged with overseeing charitable, etc., organizations. Prior law (sec. 6104(c)) already required the Service to notify the appropriate State official if the Service believed that the organization had been operated in such a way as to no longer meet the requirements of its exemption.

Elections.—Notwithstanding the concerns which caused many organizations to urge the Congress to change prior law, some organizations appeared to prefer to continue under the rules of prior law. In recognition of the fact that the Act requires some change in prior practices, especially as to the keeping of records of expenditures and the disclosure of such information on the annual return, the Act permits organizations to elect the new rules or to remain under prior law.

An election by an organization to have its legislative activities measured by the new expenditures test is to be effective for all taxable years of the organization which end after the date the election is made, and begin before the date the election is revoked by the organization. Thus, an organization can, at any time before the end of the taxable year, elect the new rules for that taxable year. Once such an election is made, it can be revoked only prospectively—that is, it cannot be revoked for a taxable year after that year has begun.

Eligible organizations.—Concerns have been expressed by a number of church groups that both prior law and the rules in the Act might violate their constitutional rights under the First Amendment. Such groups have indicated a concern that if a church were permitted to elect the new rules, then the Internal Revenue Service might be influenced by this legislation even though the church in fact did not elect.

As a result of the concerns expressed by a number of churches and in response to their specific request, the Act does not permit a church or a convention or association of churches (or an integrated auxiliary or a member of an affiliated group which includes a church, etc.), to elect to come under these provisions.[10]

The Act excludes from the new rules not only churches and conventions or associations of churches, but also integrated auxiliaries of churches or of conventions or associations of churches.

The Act also specifically provides that the new rules under the Act are not to have any effect on the way the lobbying language of section 501(c)(3) ("no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation") is to be applied to organizations which do not elect (or are ineligible to elect) to come under these rules.

Effect of court decision.—The Congress is aware of the recent tax litigation involving Christian Echoes National Ministry, Inc. In this case, the Internal Revenue Service revoked a prior favorable section 501(c)(3) exemption ruling and assessed Social Security (FICA) tax deficiencies. The organization paid the FICA taxes and sued for refund in Federal district court. The district court held for the organization (28 AFTR 2d 71–5934 (N.D. Okla. 1971)). The Government appealed directly to the United States Supreme Court, which held that it had no jurisdiction to entertain the direct appeal (404 U.S. 561 (1972)). The Government then appealed to the Court of

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[10] Since private foundations are already subject to excise taxes on activities involving influencing legislation under section 4945, they are ineligible for these new rules. Also, organizations which are public charities because they are support organizations (under sec. 509(a)(3)) of certain types of social welfare organizations (sec. 501(c)(4)), labor unions, etc. (sec. 501(c)5)), or trade associations (sec. 501(c)(6)) are ineligible to make this election.

Appeals for the Tenth Circuit, which reversed the district court decision and upheld the Government's position that the organization was not exempt because of excessive lobbying activities (470 F.2d 849 (1972)). The organization then petitioned the Supreme Court for a writ of certiorari, which was denied (414 U.S. 864 (1973)).

In the course of their opinions, the various courts stated conclusions regarding a number of legal issues or issues of mixed law and fact. If the Act and the committee reports were silent with regard to this case, then some might have argued that Congressional enactment implied Congressional ratification of the decision and of one or all of the statements in the opinions in this case. Others might have said that Congressional action constituted the sort of revision that amounted to a rejection of the decision or opinions in this case.

The Congress proceeded on this Act without evaluating that litigation. So that unwarranted inferences may not be drawn from the enactment of this Act, the Congress states that its actions are not to be regarded in any way as an approval or disapproval of the decision of the Court of Appeals for the Tenth Circuit in *Christian Echoes National Ministry, Inc.* v. *U.S.*, 470 F.2d 849 (1972), or of the reasoning in any of the opinions leading to that decision.

Effective dates

In order to provide time for the Treasury Department to promulgate the necessary regulations interpreting the Act and providing for making elections under the new rules, the Act's provisions, with certain limited exceptions, become effective only for taxable years beginning after December 31, 1976. However, the rule which provides that a section 501(c)(3) organization which loses its charitable, etc., status because of excess lobbying status cannot thereafter be exempt under section 501(c)(4) applies to activities occurring after the date of enactment (October 4, 1976). The amendments conforming the estate tax charitable deduction provisions applies to the estates of decedents dying after December 31, 1976, and the amendments conforming the gift tax charitable deduction requirements apply to gifts in calendar years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will affect budget receipts by less than $5 million annually.

8. Tax Liens, etc., Not to Constitute "Acquisition Indebtedness" (sec. 1308 of the Act and sec. 514(c)(2) of the Code)

Prior law

Generally, any organization which is exempt from Federal income tax (under section 501(a)) is taxed only on income from trades or businesses which are unrelated to the organization's exempt purposes; it is not taxed on passive investment income and income from any trade or business which is related to the organization's exempt purposes.[1]

Before 1969, some exempt organizations had used their tax-exempt status to acquire businesses through debt financing, with purchase

[1] There are some exceptions to the general rule that passive investment income is tax-exempt. For example, social clubs (sec. 501(c)(7)) and voluntary employees' beneficiary associations (sec. 501(c)(9)) are generally taxed on such income. Also, private foundations are subject to an excise tax of 4 percent on their net investment income.

money obligations to be repaid out of tax-exempt profits; for example, as from leasing the assets of acquired businesses to the businesses' former owners.

The Tax Reform Act of 1969 provided (in the so-called "Clay Brown provision") that an exempt organization's income from "debt-financed property", which is not used for its exempt function, is to be subject to tax in the proportion in which the property is financed by debt. In general, debt-financed property is defined as "any property which is held to produce income and with respect to which there is acquisition indebtedness" (sec. 514(b)(1)). A debt constitutes acquisition indebtedness with respect to property if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred "but for" the acquisition or improvement of the property.[2]

Where property "is acquired subject to a mortgage or other similar lien," the debt secured by that lien is generally considered acquisition indebtedness. The Treasury Regulations (Reg. § 1.514(c)-1(b)(2)) provide, in effect, a special rule for debts for the payment of taxes, as follows: "[I]n the case where State law provides that a tax lien attaches to property prior to the time when such lien becomes due and payable, such lien shall not be treated as similar to a mortgage until after it has become due and payable and the organization has had an opportunity to pay such lien in accordance with State law."

There has been no similar exception for State or local governments' special assessments to finance improvements.

Reasons for change

It is common practice for State and local governmental units in some States to undertake certain improvements to land, such as roads, curbs, gutters, sewer systems, etc., and to finance these improvements either through general tax revenues or special assessments imposed on the land which the improvements are intended to benefit. The immediate funds for the improvements are provided by the sale of bonds secured by liens on the land. The bonds are then paid off either through the general tax revenues or the special assessments over a period of years.

The Internal Revenue Service has taken the position that if a lien arises from a special assessment of the type described above, as opposed to a property tax lien, the lien securing the installment payments of the assessment will constitute acquisition indebtedness, even though the installment payments are due in future periods.

The indebtedness arising from a special assessment of this sort does not appear to be the type of indebtedness that the debt-financed property provisions were intended to deal with in the 1969 Act.

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[2] There are several exceptions from the term "acquisition indebtedness." For instance, one exception is indebtedness on property which an exempt organization receives by devise, bequest, or, under certain conditions, by gift. This exception allows the organization receiving the property 10 years to dispose of it free of tax under this provision, or to retain the property and reduce or discharge the indebtedness on it with tax-free income. Also, the term, "acquisition indebtedness" does not include indebtedness which was necessarily incurred in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Special exceptions are also provided for the sale of annuities and for debts insured by the Federal Housing Administration to finance low- and moderate-income housing.

Explanation of provision

The Act provides that the indebtedness with respect to which a lien arising from taxes or a lien for special assessments made by a State or an instrumentality or a subdivision of a State will not be acquisition indebtedness until and to the extent that, an amount secured by the lien becomes due and payable and the exempt organization has had an opportunity to pay the taxes or special assessments in accordance with State law.[3] However, it is not intended that this provision apply to special assessments for improvements which are not of a type normally made by a State or local governmental unit or instrumentality in circumstances in which the use of the special assessment is essentially a device for financing improvements of the sort that normally would be financed privately rather than through a government.

In determining when a lien becomes due and payable and the exempt organization has had an opportunity to pay the necessary amount in accordance with State law, consideration must be given to the realities of the situation, and not merely the formal recitations of State law. For example, Hawaii law (sec. 67–23) provides that special assessments become "due and payable" at the end of a designated 30-day period. However, a failure to pay the assessment at the end of that period constitutes, under State law, an election to pay the assessment in installments (sec. 67–23; see sec. 67–25). Sanctions are then provided (secs. 67–27 and 67–29) in the event of failure to pay the installments when due. In such a situation, the Congress intends that, for purposes of this provision, the assessment lien becomes due and payable only at the time when the relevant installment is required to be paid.

Effective date

Since this provision is intended to reflect the intent of Congress when it amended section 514 in 1969, the provision is to apply to all taxable years ending after December 31, 1969.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

9. Extension of Private Foundation Transition Rule for Sale of Business holdings (sec. 1309 of the Act and sec. 101(1)(2)(B) of the Tax Reform Act of 1969)

Prior law

The Tax Reform Act of 1969 imposed taxes upon certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of that foundation). Among the transactions to which these taxes on "self-dealing" apply are the sale, exchange, or leasing of property (sec. 4941). The 1969 Act also added a provision to the Code which limits the combined ownership of a business enterprise by a private foundation and all disqualified persons and taxes any excess holdings which are not divested within a required period of time (sec. 4943).

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[3] This amendment is intended to apply also to the definition of business-lease indebtedness in section 514(g). However, since that provision is repealed by section 1901 (a)(72)(B) of the Act, no modifying amendment is made to it.

The 1969 Act permits a private foundation to sell excess business holdings (held, or treated as held, by the foundation on May 26, 1969) to a disqualified person if the sales price equals or exceeds the fair market value of the property being sold. This rule was generally intended to allow private foundations and disqualified persons to disentangle their affairs and was based on the fact that in the case of many closely-held companies the only ready market for a private foundation's holdings would be disqualified persons. This rule has no terminal date. This rule (sec. 101(1)(2)(B) of the 1969 Act) also provides that prior to January 1, 1975, a private foundation could have sold business holdings which would have been excess business holdings but for the special "grandfather" rules in the statute (sec. 4943 (c)(4) and (5)) to disqualified persons.

Reasons for change

It has come to the attention of Congress that, despite the 5-year transitional period in which the "grandfathered" excess business holdings could have been sold to disqualified persons by private foundations, some private foundations that have wished to make such a sale or other disposition have not done so. The Congress believes generally that it is still desirable to encourage private foundations to divest themselves of holdings in enterprises in which disqualified persons have a significant interest provided that the foundation receives fair market value for the business holdings. However, the Congress continues to believe that, in general, it is still desirable to prevent most sales, exchanges, or other dispositions between a private foundation and disqualified persons and therefore it makes these sales to disqualified persons possible without imposition of the self-dealing tax only through the remainder of 1976.

Explanation of provision

The Act extends the effective date of a private foundation transitional rule in the Tax Reform Act of 1969 (sec. 101(1)(2)(B)) to make that transitional rule apply to a sale, exchange, or other disposition of the "nonexcess" business holdings referred to above which takes place before January 1, 1977. This extension does not effect any of the other requirements of section 101(1)(2)(B). Therefore, for example, the requirement that such a disposition is allowed only as to property which is owned by a private foundation on May 26, 1969 (or which is considered as having been owned by a private foundation on that date), and the requirement that the foundation receive at least fair market value for the property, are not affected by this amendment.[1]

Effective date

This provision applies to dispositions occurring after the date of enactment (October 4, 1976) and before January 1, 1977.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

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[1] In addition, if a transaction under this transitional rule involves the receipt of indebtedness by the private foundation, the receipt and holding of such indebtedness is to be governed by the rules under section 101(1)(2)(C) of the 1969 Act and Regs. § 53.4941 (d)-4(c)(4).

10. Private Foundations Imputed Interest (sec. 1310 of the Act and 4942 of the Code)

Prior law

In general, a penalty tax is imposed (sec. 4942) on any private foundation (other than an operating foundation) which fails to make charitable distributions amounting to the greater of its adjusted net income or its minimum investment return. In order to qualify as an operating foundation, an organization must make charitable distributions of substantially all of its adjusted net income directly for the active conduct of its exempt purposes. The minimum investment return is 5 percent of the average value of the foundation's noncharitable assets for the taxable year. (See above, 3. Reduction in Minimum Distribution Amount for Private Foundations.) The adjusted net income of a foundation (for purposes of these charitable distribution rules) is its gross income (including tax-exempt interest, certain capital gains, and certain amounts treated as qualifying distributions from other private foundations) less trade or business expenses, expenses for the production or collection of income, depreciation, and cost depletion. Adjusted net income includes imputed interest.

Reasons for change

It has come to the attention of the Congress that there are some foundations which sold property prior to the enactment of the rules applicable to foundations in 1969 on an installment sales basis that did not call for a stated rate of interest. Prior to the enactment of the private foundation rules, whether the foundation had interest income was not relevant because the foundation paid no Federal taxes on interest income. However, with the enactment of the private foundation rules, the requirement that an operating foundation distribute income imputed to the foundation (under sec. 483) could be onerous. The foundation might either be forced to expand drastically its ongoing active program, or be forced to make one-time grants, which cause it to fail one of the requirements for operating foundation status (spending substantially all of its income for the *active conduct* of its exempt activities, as distinguished from making grants). The consequences to a nonoperating foundation, although not apt to be as severe, nevertheless might include disruption of otherwise appropriate charitable expenditure planning. Consequently, the Congress does not believe that it is appropriate to require a foundation to distribute income which is imputed to it because of a sale made before the Tax Reform Act of 1969.

Explanation of provision

The Act changes the definition of adjusted net income for purposes of determining how much must be distributed or spent (to avoid tax under sec. 4942) to exclude interest income imputed to the foundation (sec. 483) in the case of sales made before the 1969 Act. Although the private foundation will not be required to distribute any income imputed to the foundation. Because of such a sale, the imputed income is still included in the net investment income of the private foundation for purposes of the 4-percent tax (provided by secs. 4940 and 4948).

Effective date

This provision applies to taxable years ending after the date of enactment (i.e., after October 4. 1976).

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

11. Unrelated Business Income From Services Provided by a Tax-exempt Hospital to Other Tax-exempt Hospitals (sec. 1311 of the Act and sec. 513 of the Code)

Prior law

A tax is imposed (secs. 511 through 514) on income from the unrelated trades or businesses of most exempt organizations, including hospitals which are exempt under section 501(c)(3) (relating to organizations organized and operated for religious, charitable, scientific, educational, etc. purposes). The term "unrelated trade or business" is defined (sec. 513) as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of any religious, charitable, scientific, educational, etc., purpose. In Rev. Rul. 69–633, 1969–2 CB 121, the Internal Revenue Service ruled that income which a tax-exempt hospital derives from providing laundry services to other tax-exempt hospitals constitutes unrelated business taxable income to the hospital providing the services, since the providing of services to other hospitals is not substantially related to the exempt purposes of the hospital providing the services.

Reasons for change

Under present law, a tax-exempt hospital which directly provides certain services needed in its function as an exempt hospital is not taxed on the imputed income from those services. In addition, under present law (as expanded by other amendments made by the Act; see below, 12. Clinical Services Provided to Tax-exempt Hospitals), several tax-exempt hospitals can create and operate, on a cooperative basis, a new tax-exempt organization to provide those services to its members.

However, it is often impractical for a number of small hospitals to perform these services directly or to create a separate cooperatively-operated organization to provide these services. Instead, it may be more practical for one hospital to provide these services to several small tax-exempt hospitals for a fee. The Congress believes that such arrangements should be encouraged since they often result in a cost savings to the hospital and its patients. Moreover, the Congress does not believe that a hospital providing such services substantially competes with other organizations which are not tax-exempt.

Explanation of provision

The Act provides that a hospital is not engaged in an unrelated trade or business simply because it provides services to other hospitals

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if those services could have been provided, on a tax-free basis, by a cooperative organization consisting of several tax-exempt hospitals. The exclusion from the unrelated business tax applies only where (1) the services are provided only to other tax-exempt hospitals, each one of which has facilities to serve not more than 100 inpatients, and (2) the services would be consistent with the recipient hospital's exempt purposes. In addition, the exemption from the unrelated business income tax is provided only to the extent that the services are provided at a fee or other charge that does not exceed the actual cost of providing those services plus a reasonable amount for a return on the capital goods used in providing those services. For this purpose, the actual cost of providing the services includes straight-line depreciation. The Congress intends that the IRS not require that hospitals providing the services keep detailed records to substantiate compliance with this new requirement, so long as the fees charged for the services provided by the hospital reasonably approximate the cost of providing those services.

Effective date

This amendment applies to all "open" taxable years to which the Internal Revenue Code of 1954 applies.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

12. Clinical Services Provided to Tax-exempt Hospitals (sec. 1312 of the Act an sec. 501(e) of the Code)

Prior law

Under prior law (sec. 501(e)), certain cooperatively-operated service organizations which have been created by tax-exempt hospitals are also considered to be tax-exempt charitable organizations. In order to qualify for that tax-exempt status, a hospital service organization (1) must be organized and operated solely to perform certain specified services which, if performed directly by a tax-exempt hospital, would constitute activities in the exercise or performance of the purpose or function constituting the basis for its exemption, and (2) must perform these services solely for two or more tax-exempt hospitals. That provision does not apply to organizations which perform services other than those listed in the statute, such as clinical services.

Reasons for change

The Congress believes that it is appropriate to encourage the creation and operation of cooperative service organizations by exempt hospitals because of the cost savings to the hospitals and their patients that result from providing certain services, such as clinical services, on a cooperative basis. Moreover, exemption from State taxation which this would facilitate in many cases would be particularly helpful in the case of clinical services, since they require relatively substantial investments in plant and equipment. In addition, under present law, it is possible for a cooperatively-operated clinical facility to avoid paying any Federal income tax if it returns any excess income to its exempt hospital members as patronage dividends.

Explanation of provision

The Act adds the performance of clinical services to the types of services that can be performed on a cooperative basis by tax-exempt hospitals. Thus, it is permissible, under the Act, for tax-exempt hospitals to create a cooperative service organization to provide clinical facilities to these hospitals.

Effective date

The amendment is effective for taxable years ending after December 31, 1976.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

13. Exemption of Certain Amateur Athletic Organizations From Tax (sec. 1313 of the Act and secs. 170, 501, 2055, and 2522 of the Code)

Prior law

Under prior law, organizations which teach youth or which are affiliated with charitable organizations have been able to qualify for exemption under section 501(c)(3) and have been eligible to receive tax-deductible contributions. Other organizations which foster national or international amateur sports competition may be exempt from taxation under other provisions (such as section 501(c)(4) (relating to social welfare organizations) or 501(c)(6) (relating to business leagues)) but often do not qualify to receive tax-deductible contributions.

Reasons for change

Prior policy on the qualification for section 501(c)(3) status has been a source of confusion and inequity for amateur sports organizations whereby some gained favored tax-exempt status while others, apparently equally deserving, did not. The failure of some of these organizations to obtain section 501(c)(3) status and to qualify to receive tax-deductible contributions has discouraged contributions to these organizations, and has deterred other organizations from going through the legal expense of applying to the Internal Revenue Service for recognition of section 501(c)(3) status. Congress believes that it is, in general, appropriate to treat the fostering of national or international amateur sports competition as a charitable purpose.
Congress believes that it is, in general, appropriate to treat the fostering of national or international amateur sports competition as a charitable purpose.

Explanation of provision

The Act permits an organization the primary purpose of which is to foster national or international amateur sports competition to qualify as an organization described in section 501(c)(3) and to receive tax-deductible contributions, but only if no part of the organization's activities involves the provision of athletic facilities or equipment. This restriction on the provision of athletic facilities and equipment is intended to prevent the allowance of these benefits for organizations which, like social clubs, provide facilities and equipment for their members. This provision is not intended to adversely affect the qualification for charitable tax-exempt status or tax deductible contributions of any organization which would qualify under the standards of prior law.

Effective date

This provision applies on October 5, 1976 (the day following the date of enactment).

Revenue effect

It is estimated that this provision will result in a revenue loss of less than $5 million annually.

M. CAPITAL GAINS AND LOSSES

1. Deduction of Capital Losses Against Ordinary Income (sec. 1401 of the Act and sec. 1211 of the Code)

Prior law

Capital losses of individuals are deductible in full against capital gains, but under prior law the excess of capital losses over capital gains could be deducted only against up to $1,000 of ordinary income each year ($500 for a married person who files a separate return). Only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income. Thus, $2,000 of net long-term capital losses is required to offset $1,000 of ordinary income. Capital losses in excess of the limitation may be carried over to future years indefinitely.

Reasons for change

The Congress believed that the $1,000 limit on the deduction of capital losses against ordinary income, which has been in the law since 1942, was too strict. Consumer prices have risen significantly since this limit was originally enacted, and taxpayers who have capital losses which are not offset by capital gains should be able to deduct a greater amount against ordinary income.

Congress believed, however, that it is appropriate to retain some limitations on the deduction of net capital losses against ordinary income. Because taxpayers have discretion over when they realize their capital gains and losses, unlimited deductibility of net capital losses against ordinary income would encourage investors to realize their capital losses immediately to gain the benefit of the deduction against ordinary income but to defer realization of their capital gains.

Explanation of provision

The Act increases the amount of ordinary income against which capital losses may be deducted from $1,000 to $2,000 in 1977 and to $3,000 in 1978 and future years. These amounts are halved for married persons who file separate returns. As under prior law, only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income.

Effective date

This provision is to apply to taxable years beginning after December 31, 1976.

Revenue effect

This provision will reduce receipts by $22 million in fiscal year 1977, $162 million in fiscal year 1978 and $273 million in fiscal year 1981.

2. Increase in Holding Period for Long-Term Capital Gains (sec. 1402 of the Act and sec. 1222 of the Code)

Prior law

Under prior law, gains or losses on capital assets held for more than six months were considered long-term capital gains or losses. For individuals, 50 percent of the excess of net long-term capital gains over net short-term capital losses is excluded from income, and the excess of net long-term capital losses over net short-term capital gains must be reduced by 50 percent before being deducted against ordinary income (up to the $1,000 limitation which was raised to $3,000 in this Act). Also, individuals may elect to have the initial $50,000 of net long-term capital gains taxed at an alternative rate of 25 percent.

In the case of corporations, the excess of net long-term capital gains over net short-term capital losses is taxed at an alternative rate of 30 percent, rather than at the regular 48-percent corporate rate. However, corporations whose taxable incomes (including capital gains) are less than $50,000 would be taxed at the lower normal tax rates.

Gains realized on the sale or exchange of captial assets held for not more than six months were considered as short-term capital gains that are not eligible for the exclusion or alternative rate.

Reasons for change

A distinction is made between short-term and long-term capital gains with respect to two major considerations. In both respects, careful examination of the function of the distinction has led Congress to the conclusion that the six-month holding period was inappropriately short.

First, the special capital gains treatment is provided for long-term gains in recognition of the fact the gain on the sale of an asset which is attributable to the appreciation in value of the asset over a long period of time otherwise would be taxed in one year and, in the case of an individual, at progressive rates.

Second, it is argued that there should be special tax treatment for gains on assets held for investment but not on those held for speculative profit. The underlying concept is that a person who holds an asset for only a short time is primarily interested in obtaining quick gains from short-term market fluctuations, which is a distinctively speculative activity. In contrast, the person who holds an asset for a long time probably is interested fundamentally in the income from his investment and in the long-term appreciation value.

Congress believed that both of these reasons for distinguishing between long-term and short-term capital gains suggest that the holding period should be one full year. The six-month holding period cannot be justified by the unfairness that results from taxing income accrued over a long period of time in a single year at progressive rates (the so-called "bunching" problem). This argument clearly suggests a holding period of one year, since tax liability for all other types of income is determined on an annual basis.

Also, while there is no clearcut analytical distinction between investment and speculative gains, Congress believed that gains on assets held between six months and one year are essentially similar in character to those held less than six months.

Explanation of provision

The Act increases the holding period defining long-term capital gains from six months to nine months in 1977 and to one year in 1978 and future years. There is a transitional rule for installment sales, whereby if a gain would have been long-term in the year of the sale, it is considered long-term even if it is included in income on the installment basis in a year in which it would have been considered short-term. Gains on agricultural commodity futures contracts (but not options on future contracts) are exempted from the increase in the holding period. The Act amends the provision which required that in certain circumstances timber cut during a taxable year received capital gain treatment only if held for 6 months prior to that taxable year. Since the Act increases this 6-month period to 9 months in 1977 and for 12 months in subsequent years, the requirement that the holding period be determined by the beginning of the year of cutting is eliminated. Thus, timber is to have the same holding period for long-term capital gain treatment as all other assets generally.

Effective date

This provision is to apply to taxable years beginning after December 31, 1976.

In the case of a short sale made in a taxable year beginning in 1976 and closed in a taxable year beginning in 1977, when the taxpayer owns substantially identical property, the property used to close the short sale will have to have been held by the taxpayer for more than 9 months in order for the gain or loss on the short sale to be long-term. Similarly, for such short sales "against the box" closed in taxable years beginning in 1978, the holding period must be more than one year.

Revenue effect

It is estimated that this provision will result in an increase in tax receipts of $33 million for fiscal year 1977, $218 million for 1978, and $407 million for 1981.

3. Capital Loss Carryover for Regulated Investment Companies (sec. 1403 of the Act and sec. 1212 of the Code)

Prior law

Generally, corporations may deduct their capital losses against their capital gains and may carry back any excess capital losses 3 years and carryover any additional capital losses for up to 5 years. In this 3-year carryback and 5-year carryforward period, corporations generally may offset their net capital losses only against their capital gains in these years.

However, under prior law regulated investment companies (mutual funds) could only carry over their net capital losses for 5 years and were allowed no carryback.

Reasons for change

Regulated investment companies are a way for relatively small investors to invest in common stocks and other securities. Generally, when a regulated investment company distributes a substantial fraction of its income to shareholders, it is exempt from the corporate income tax. The general intent of Congress has been that the income from these investments should be treated as if the individual shareholders were investing directly in the securities that they own through the mutual fund.

In some respects, however, the law treats an individual who invests through a mutual fund more harshly than one who invests directly. Regulated investment companies could carry their capital losses forward for only five years, so unless they had capital gains in this period, the individual shareholders could lose the benefit of deducting these capital losses against capital gains received by the mutual fund. (When they sell their shares in the mutual fund, however, they may deduct any capital loss on their shares against their other capital gains and a limited amount of ordinary income.) Individuals who invest in securities directly, however, are permitted an unlimited capital loss carryover and also could deduct capital losses against up to $1,000 of ordinary income each year (an amount that is raised to $3,000 in this Act).

Mutual funds were also treated more harshly than other corporations which, in addition to the 5-year carryover for net capital losses, also have a 3-year carryback for such losses. Since mutual funds distribute most of their capital gains currently, they could derive little benefit from the 3-year capital loss carryback even if it were extended to them. Thus, while corporations generally can net their capital gains and losses over a 9-year period, regulated investment companies are limited to a 6-year period. In view of this and since regulated investment companies are essentially conduits for their individual shareholders, Congress believed it was appropriate to extend the 5-year carryforward period for capital losses by 3 additional years.

Explanation of provision

The Act extends the capital loss carryover period for regulated investment companies from five years to eight years. To receive the eight-year carryforward, a corporation must be a regulated investment company in both the year the capital loss is incurred and the year it is deducted.

Effective date

The eight-year carryover is to apply to loss years ending on or after January 1, 1970.

Revenue effect

It is estimated that this provision will result in a decrease in tax receipts of $13 million for fiscal year 1977, $21 million for 1978, and $51 million for 1981.

4. Gain on Sale of Residence by Elderly (sec. 1404 of the Act and sec. 121(b) of the Code)

Prior law

Under prior law, if a taxpayer who had attained age 65 sold his principal residence, he could exclude from income the entire gain on the sale if the adjusted sales price were $20,000 or less. If the adjusted sales price exceeded $20,000, he could exclude that portion of the gain in the ratio of which $20,000 bore to the adjusted sales price.

Reasons for change

This provision of prior law was first enacted in the Revenue Act of 1964.

The sale price of homes has gone upward along with the general price level since the senior citizen exclusion was instituted in 1964. According to the Bureau of the Census, the median sales price of single family homes in 1964 was $22,400. This figure reached more than $40,000 in 1976. In other words, the sale price of homes has about doubled since the exclusion was established.

The Congress believed that the exclusion should be increased to restore the senior citizen's exclusion closer to its comparable level in 1964.

Explanation of provision

The Act increases from $20,000 to $35,000 the adjusted sales price limitation which determines the maximum amount which taxpayers age 65 or over can exclude from capital gains tax upon sale of principal residences.

Effective date

The provision applies to sales or exchanges occurring in taxable years beginning after December 31, 1976.

Revenue effect

This provision is expected to decrease revenues by $4 million in fiscal 1977 and $25 million annually thereafter.

N. PENSION AND INSURANCE TAXATION

1. Individual Retirement Account (IRA) for Spouse (sec. 1501 of the Act and sec. 220 of the Code)

Prior law

Under prior law, the IRA deduction could not exceed $1,500 or 15 percent of compensation (whichever is less), so that a person without compensation from employment or self-employment was not allowed an IRA deduction. The IRA deduction was not allowed to a person for a contribution to the IRA of another person. Also, the IRA deduction for a year was allowed only for IRA contributions made during the year.

Reasons for change

Prior law did not permit an employee to make deductible contributions to an IRA for the benefit of a spouse not working outside the home. Consequently a spouse who did not have income from employment or self-employment did not have equal access to a tax-deferred retirement program under prior law. The Congress believes that this was unfair to a spouse who receives no compensation but performs valuable household work.

In order to extend the benefits of an IRA to homemakers, the Congress added a provision which permits employees to set aside retirement savings for their uncompensated spouses.

Explanation of provision

Under the Act, an individual with compensation (and who is eligible to deduct IRA contributions) can contribute up to $875 to his own IRA and $875 to an IRA separately owned by his spouse or can contribute up to $1,750 to an IRA which credits $875 to a subaccount for the husband and $875 to a subaccount for his wife. (The single account with two subaccounts could be considered a common investment fund.)

Under the Act, an individual's earnings and the ownership of accounts (or subaccounts) are determined without regard to community property laws.

Although the spouses own separate subaccounts, each could have a right of survivorship with respect to the subaccount of the other. As under prior law, the deduction cannot exceed 15 percent of compensation. Under the Act, an IRA deduction is allowed under the new rules or the prior rules (but not both).

The expanded IRA rules are available for a taxable year during which only one spouse is employed and the other spouse has no earnings and is not an active participant in a tax-favored retirement plan or a government plan. For example, if a husband works all year, and his wife receives no compensation and is not an active participant in a plan at any time during the year, the expanded IRA rules will apply.

If the spouses have different taxable years, the usual $1,500 IRA limit will apply (rather than the $1,750 limit), for example, to a contribution by the husband if his wife receives compensation during her taxable year ending with or within the taxable year of her husband. If both husband and wife receive compensation at any time during the taxable year, each could deduct contributions to an IRA under the rules for separate IRAs, if each is otherwise entitled to deduct such contributions.

Under the Act, if a contribution is made during the first 45 days of a year on account of the previous year, the deduction for the contribution is allowed for the previous year, on the basis of the facts and law applicable for the previous year, as if the contribution were made on the last day of the previous year.

The Act modifies the prior law under which penalties were imposed on an IRA contribution in excess of the deductible limitations. Under the Act, penalties will not be imposed if the contribution does not exceed $1,500 (or $1,750, whichever applies) and the excess over 15 percent of earnings is withdrawn from the IRA before the time the tax return for the year of the excess contribution is due (including extensions).

Effective date

The provision applies to taxable years beginning after December 31, 1976.

Revenue effect

This provision is expected to produce a revenue loss of $2 million in fiscal 1977, $14 million in fiscal 1978, $15 million in fiscal 1979, and $17 million annually thereafter.

2. Limitation on Contributions to Certain H.R. 10 Plans (sec. 1502 of the Act and secs. 415(c) and 404(e)(4) of the Code)

Prior law

Under prior law, a self-employed individual could set aside a minimum contribution of up to $750 of self-employment income in an H.R. 10 plan without regard to the rule generally limiting H.R. 10 plan contributions to 15 percent of self-employment income. However, due to a technicality in the law, a plan could have been disqualified if the contribution exceeded 25 percent of the individual's self-employment income.

Reasons for change

The minimum contribution rule was enacted in order to enable certain organizations of the self-employed (such as the Jockeys' Guild) to set up retirement plans for their members without having to confront complex recordkeeping and administrative problems, and in order to allow any moderate or lower income self-employed individual who wishes to do so to save for retirement. The 25-percent ceiling on allocations under defined contribution plans, however, generally made the $750 limitation unavailable to its intended beneficiaries.

Explanation of provision

The Act allows a self-employed individual to set aside up to $750 of self-employment income in an H.R. 10 plan without regard to the usual 15-percent limitation or the 25-percent limitation. The exception only applies if the individual's adjusted gross income (determined separately in the case of a married individual, without regard to the deduction for the minimum contribution, and without regard to community property laws) does not exceed $15,000. The $15,000 limit insures that the provision is limited to its intended beneficiaries—low- and moderate-income taxpayers.

Effective date

The provision applies to years beginning after December 31, 1975.

Revenue effect

The revenue decrease from this provision is expected to be negligible.

3. Retirement Deductions for Members of Armed Forces Reserves, National Guard and Volunteer Firefighters (sec. 1503 of the Act and sec. 219(c) of the Code)

Prior law

Prior law provided that a participant in a governmental plan was not allowed a deduction for an IRA contribution, so that the deduction was not allowed to members of the Armed Forces Reserves or National Guard covered by a military retirement plan or to members of a volunteer fire department covered by a governmental plan for firefighters.

Reasons for change

The rule prohibiting contributions to IRAs by a participant in a governmental plan denied IRA deductions to members of the National Guard and Armed Forces Reserves because they were covered by the U.S. military retirement plan. Generally, under this plan, members of the Reserves or Guard who serve for less than 20 years are not entitled to benefits. Consequently, many members of the Reserves or Guard were denied individual retirement account deductions even though they will not obtain benefits under the Government's plan.

The rule of prior law also denied the deduction to a person who would otherwise qualify but who was covered by a governmental plan for volunteer firefighters. These plans generally provide very small benefits; yet under prior law they precluded participants from establishing IRAs.

Explanation of provision

The Act allows a member of the Armed Forces Reserves or National Guard to qualify for an IRA deduction for a year (if otherwise qualified) despite participation in the military retirement plan if the member has 90 or fewer days of active duty (other than for training) during the year. It also extends the deduction for contributions to an IRA to an individual who would be eligible for the deduction but for membership in a volunteer fire department or in a governmental plan for volunteer firefighters. The deduction is limited to firefighters who have not accrued an annual benefit in excess of $1,800 (when expressed as a single life annuity payable at age 65) under a firefighters' plan.

Effective date

The provision applies to taxable years beginning after December 31, 1975.

Revenue effect

The Armed Forces Reserves and National Guard provisions are expected to decrease revenue by $6 million in fiscal 1977 and $5 million annually thereafter. The firefighters' provision is expected to have a negligible revenue impact.

4. Tax-Exempt Annuity Contracts in Closed-End Mutual Funds (sec. 1504 of the Act and sec. 403(b) of the Code)

Prior law

Under prior law, amounts contributed by certain tax-exempt organizations and educational institutions to provide annuities for employees were excluded from the income of the employees but only if the contributions were invested in open-end mutual funds (and used to provide a retirement benefit), or used to purchase annuity contracts. (An open-end mutual fund is a regulated investment company which issues redeemable shares.) Contributions invested in a closed-end investment company (a regulated investment company which does not issue redeemable shares) did not qualify for this exclusion.

Reasons for change

Closed-end investment companies are regulated investment companies subject to the same regulation by the Securities and Exchange Commission and the Internal Revenue Service as are open-end funds, and they similarly offer professional asset management of a diversified investment portfolio. In addition, a closed-end investment company can offer a retirement benefit by providing a stock disposition arrangement under which stock is sold by the company on behalf of the shareholders on a monthly basis without commissions and the proceeds are remitted to the shareholders at a nominal charge. Such an arrangement is similar to the stock redemption arrangements offered by certain open-end mutual funds and can be used to provide a retirement benefit. Consequently, the exclusion of closed-end investment companies which provide retirement benefits under these rules did not appear to be appropriate.

Explanation of provision

The Act allows contributions for tax-sheltered annuities to be made to closed-end as well as to open-end mutual funds and annuity contracts.

Effective date

The provision applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision is expected to decrease revenues by a negligible amount.

5. Pension Fund Investments in Segregated Asset Accounts of Life Insurance Companies (sec. 1505 of the Act and sec. 801(g) of the Code)

Prior law

A segregated asset account can serve as a life insurance company's investment account and reserve for an insurance contract providing for annuities under which the premiums or benefits depend on the performance of the assets in the account. However, the Internal Revenue Service had taken the position that a segregated asset account could be used as the basis for a reserve for a contract by a particular life insurance company only if that life insurance company provided annuities under the contract.

Reasons for change

An employer who wished to have its qualified pension fund invested in a segregated asset account held by a particular life insurance company but wished to purchase annuities from another life insurance company (or to provide annuity benefits directly from an employee trust) was unable to do so under the prior IRS position without incurring the cost of compensating the holder of the account for annuity purchase rate guarantees that would not be utilized. This cost is unnecessary and would not be incurred in these circumstances if the holder of the account were not required by the tax law to provide annuity contracts with respect to the account.

Explanation of provision

The Act clarifies present law by allowing a qualified pension plan to invest in an insurance contract with a segregated asset account even though the contract does not provide annuities. Under the Act, a pension fund can invest assets in such an account in lieu of a trust if the investment is otherwise permitted under law. The Act also clarifies the treatment of pension fund investments in nonsegregated accounts. The provision does not in any way modify the requirements of title I of the Employee Retirement Income Security Act which requires certain pension plan assets to be held in a trust.

Effective date

The provision applies for taxable years beginning after December 31, 1975.

Revenue effect

There is expected to be no revenue effect from this provision.

6. Study of Salary Reduction Pension Plans (sec. 1506 of the Act)

Prior law

On December 6, 1972, the IRS issued proposed regulations which would have changed the tax treatment of salary reduction, cafeteria, and cash or deferred profit-sharing plans. In order to allow time for Congressional study of these areas, section 2006 of ERISA provided for a temporary freeze of the status quo until December 31, 1976.

Reasons for change

The Congress believes it is not possible to study adequately the questions involved in order to enact permanent legislation regarding salary reduction and cash and deferred profit-sharing plans prior to the January 1, 1977 end of the temporary freeze of the status quo provided for in section 2006 of ERISA. The Congress therefore decided to extend the time for the Congressional review of the treatment of these plans.

Explanation of provision

Under the Act, the temporary freeze of the status quo (under which plans in existence on June 27, 1974, are governed by the law in effect prior to the 1972 proposed regulations) is extended until January 1, 1978.

Effective date

This provision is effective upon enactment.

Revenue effect

This provision has no effect on revenues.

7. Consolidated Returns for Life and Mutual Insurance Companies (sec. 1507 of the Act and secs. 1504(c), 821(d), and 1503(c) of the Code)

Prior law

Under prior law, life insurance companies could not file consolidated returns with non-life companies. In addition, mutual casualty insurers were effectively precluded from filing consolidated returns with other types of companies.

Reasons for change

The present ban on life companies filing consolidated returns with other companies historically has been based on the fact that life insurance companies have been taxed quite differently from other companies. In their case, Congress has been concerned that in any event a tax should be imposed, at the regular rate, on an amount approximately equal to their taxable investment income. For this reason, for example, limitations were imposed on the extent to which policyholder dividends could in effect reduce taxable investment income. As a result, Congress in the past has not allowed life insurance companies to file consolidated returns with other types of companies and in this manner offset their taxable investment income against losses realized from other types of operations.

It is recognized, however, that consolidated returns and offsets of losses are allowed in the case of many diverse types of businesses, some of which are also subject to special tax provisions. Moreover, it is recognized that the recent recession and inflation in prices has caused many casualty insurance companies to incur large losses. If a stock casualty company and a noninsurance company are affiliated, they can file a consolidated return on which the losses of the casualty company are applied against the other company's profits. However, if the other company is a life insurance company, the losses of the casualty company can only be applied against the casualty company's income (by means of loss carryovers and carrybacks); they cannot be applied against the life company's income. Consequently, the ban on life-nonlife consolidations has been a hardship for casualty companies which are affiliated with life companies.

For these reasons Congress adopted a provision which preserves the concept that some tax be paid with respect to the life insurance company's investment income (except where the company itself has an overall loss from operations), but which at the same time provides substantial relief in the future for casualty companies with losses.

Explanation of provision

The Act allows mutual or stock life companies and other mutual insurance companies to elect to join in the filing of consolidated returns with other types of corporations which are under the same common control and which meet the stock ownership requirements of an "affiliated group." Consolidations of life and nonlife companies however, are subject to certain limitations as to the extent of the loss offsets as indicated below. The filing of a consolidated return by an affiliated group which includes a life company and a property-liability company will permit the tax savings from the property-liability company's losses to be taken into account sooner in computing its statutory surplus.

Election.—The Act provides that under regulations prescribed by the Treasury Department, the common parent of an affiliated group which includes a life company or other mutual insurance company may elect to include such a company in the filing of a consolidated return with other corporations for any taxable year beginning on or after January 1, 1981. Once this election is made, all insurance companies in the affiliated group, as well as other members of the group, must continue to file consolidated returns unless the group obtains the right to revoke its election under the applicable Treasury Department regulations. If this election is not made, prior law will continue to apply. That is, in such cases the life and other mutual insurance companies will continue to be treated as "nonincludible" corporations, but under the Act (as under prior law) two or more life companies (which meet the definition of an "affiliated group") may still continue to file a consolidated return with each other.

It is understood that although generally companies will probably desire to file consolidated returns with life or other mutual insurance companies, some may choose to continue to file separate returns as they did under prior law. Where this occurs, it is likely to arise from the fact that the parent corporation (whose year the other members joining in the filing of the consolidated return must follow) uses a fiscal year as its taxable year. Some life companies may not want to adopt a taxable year other than a calendar year since filings with State insurance commissioners are required by these life companies on a calendar year basis.

To facilitate the filing of consolidated returns with life companies where the common parent has a fiscal year, the Act waives in this case the general requirement of the tax law (sec. 843 of the Code) that insurance companies must use the calendar year as their taxable year. However, the use of a fiscal year by an insurance company is not intended to affect the applicable method of accounting required of the insurance company by the tax law (subchapter L). In this case it is expected that the regulations will require the insurance companies to maintain adequate records reconciling all of the items on its fiscal year tax return with the corresponding items on its calendar year statements filed with the State insurance commissioners.

Limitation on certain losses.—For reasons previously indicated, the Act imposes limitations on the amount of consolidated net operating loss which can be applied against the income of a life company. Under the limitations, the amount of the loss which may be taken into account in any one year is limited to 35 percent of the taxable income of the life companies included in the group or to 35 percent of the sum of the losses for the current year and for prior years, whichever is less. (For 1981 and 1982, the percentages are 25 percent and 30 percent, respectively.) The taxable income of each life company for this purpose is its "life insurance company taxable income" (as defined in sec. 802(b) of the Code), but determined without regard to its so-called phase III income. Any portion of a loss which is not taken into account because of the limitations may be offset against the income of a life company member as a carryforward, but not as a carryback.

The limitations outlined above can be illustrated by an example. Assume a life insurance company has a subsidiary (1) which is not an insurance company, and (2) which incurs a net operating loss of $120 in 1985 ($20 of which is absorbed by a carryback against the subsidiary's own prior year's income). Assume further that the parent company's life insurance company taxable income for 1985 (determined without regard to its phase III income under sec. 802(b)(3)) is $150. The amount of the subsidiary's loss which can be applied against the parent's income for 1985 is $35 (35 percent of the available loss), since this is less than 35 percent of the parent's income for the year. If in 1986 the subsidiary has a net operating loss of $60 and the parent has taxable investment income of $200 (without regard to its phase III income), the amount of the loss offset for 1986 would be $44 (35 percent of the sum of the current year's loss and the loss carryover). The losses which can be carried over to subsequent years in this case follow the usual rules applicable to loss carryovers so that, for example, the loss carryover to 1987 would consist of a $65 loss from 1985 and a $16 loss from 1986. (In subsequent years, these carryovers would be applied under the usual rules so that the carryover from 1985 would be applied before the carryover from 1986.)

If in the above example the parent had $80 of income in 1986 (rather than $200), the amount of the loss offset for that year would be limited to $28 (35 percent of the parent's income for the year), which is less than $44.

Other rules.—Under the Act the details of the computation of the tax liability of an affiliated group which includes life or other mutual insurance companies are to be determined under regulations issued by the Treasury Department. Also, an election to consolidate life and nonlife companies cannot be revoked without the consent of the Internal Revenue Service. (This is the same approach as is generally taken under the tax law with respect to other affiliated groups.)

The Act also provides that a life company cannot file a consolidated return with another type of company unless they have been affiliated for the preceding 5 years. If a nonlife company joins in a consolidated return with an affiliated group that includes a life company, the losses of that nonlife company cannot be offset against the income of the life company unless the nonlife company has been a member of the group for the preceding 5 years.

For other mutual insurance companies included in the affiliated group and included in consolidated returns, the Act requires that the regular normal corporate tax rates apply rather than the special rates provided for small companies.

Another special rule makes it clear that the enactment of the new provisions is not to result in the termination of an affiliated group. For example, assume that a life company owns 100 percent of a subsidiary which in turn owns 100 percent of a second subsidiary. Assume further that the first and second subsidiaries are not life companies but elect to file consolidated returns under this provision. If the life company also elects to join in the filing of a consolidated return, then the affiliated group of the two subsidiaries would not be treated as having been terminated (as a result, any deferred intercompany transactions between the subsidiaries would not be treated as giving rise to taxable income).

Effective date

The Act is effective for taxable years beginning after December 31, 1980. However, a transitional rule is provided to limit the use of carryovers of losses and credits for pre-1981 years. These carryovers are to be treated as if the Act had not been enacted. This means that the ability to absorb these losses or credits is not to be changed as a result of the new election to include life or other mutual insurance companies in a consolidated return with other companies. The same principles also apply with respect to losses and credits which could otherwise be carried back to pre-1981 years.

To illustrate this rule, assume that a noninsurance company owns both another noninsurance company and also a life company. Assume that the two noninsurance companies presently file consolidated returns. If this affiliated group has consolidated net operating losses in 1980 which can be carried to 1981, even though an election is made for 1981 to include the life company in the consolidated return, the absorption of this loss is to be determined as if the new consolidation rules do not apply. This means that the life company's profits are not to be available to offset any part of this carryover loss. In addition, if in 1981 the parent noninsurance corporation were to acquire a profitable property-liability company (or other company not directly affected by the new rules) and under normal consolidated return rules these profits could be utilized in determining how much of the 1980 loss could be absorbed, the use of these profits in this manner would not be affected by the new rules. However, if the life company were to acquire this profitable corporation, its profits would not be available to offset the noninsurance company 1980 loss, because the profitable member in this case would be a subsidiary of the life company and would not be treated as a member of the nonlife insurance group.

Revenue effect

There is no revenue effect through fiscal 1981.

8. Guaranteed Renewable Life Insurance Contracts (sec. 1508 of the Act and sec. 809(d)(5) of the Code)

Prior law

Generally, a life insurance company can deduct 10 percent of the increase in its reserves for nonparticipating contracts for a taxable year or, if greater, 3 percent of the premiums for the year (excluding the portion of the premiums which was allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) if the policies are issued or renewed for at least 5 years.

Reasons for change

Under prior law, controversy had arisen where, for example, a one-year nonparticipating term life insurance policy was guaranteed by the life insurance company to be renewable by the policyholder for five years. The Internal Revenue Service had contended that because such a policy was issued and renewed for a one-year period, the deduction for nonparticipating policies was not allowable. Taxpayers contended that because of the five-year renewable right, the policy should be treated as a five-year policy and that the deduction was therefore allowable.

Explanation of provision

The Act provides that the time for which a policy is issued or renewed includes the period for which the insurer guarantees that the policy is renewable by the policyholder.

Effective date

The provision is effective as of the general effective date of the Life Insurance Company Income Tax Act of 1959; that is, it applies to taxable years beginning after December 31, 1957.

Revenue effect

The revenue effect of this provision is expected to be negligible.

9. Study of Expanded Participation in Individual Retirement Accounts (sec. 1509 of the Act)

Prior law

An individual who is an active participant in a qualified pension, etc., plan, a tax-sheltered annuity, or a governmental plan generally cannot make deductible contributions to an IRA.

Reasons for change

If an employee is an active participant in a qualified pension plan, he or she is not allowed to make deductible contributions to an IRA or to the plan. Even though the benefits provided by such a plan may be less than the employee could provide under an IRA, the employee is not allowed to make up the difference through deductible IRA contributions or by making deductible contributions to the plan. The Congress understands that, as a result, some employees under such plans have withdrawn from active plan participation and additional employees may begin to withdraw in the near future. In some cases, however, plan participation is mandatory, and the employees are unable to withdraw. It appears that the problem may be most acute for plans established before enactment of ERISA because those plans were designed without taking IRAs into account.

Explanation of provision

The Act provides that the staff of the Joint Committee on Taxation is to study the concept of allowing an IRA deduction to a participant in a qualified plan or tax-sheltered annuity. The staff is to report its findings to the Ways and Means Committee of the House and the Finance Committee of the Senate.

Effective date

The provision is effective upon enactment.

Revenue effect

This provision has no revenue effect.

10. Taxable Status of Pension Benefit Guaranty Corporation (sec. 1510 of the Act and sec. 4002(g)(1) of the Employee Retirement Income Security Act of 1974)

Prior law

A corporation organized under an Act of Congress is not generally exempt from Federal taxation unless that Act so provides. The Pension Benefit Guaranty Corporation was not specifically exempted from Federal taxation by ERISA (The Employee Retirement Income Security Act of 1974).[1]

Reasons for change

The Congress intended the PBGC to be exempt from Federal taxation, but this exemption was apparently deleted from the final bill through an oversight.

Explanation of provision

The Act amends ERISA to clarify the intent of Congress that the Pension Benefit Guaranty Corporation is to be exempt from all Federal taxation except taxes imposed under the Federal Insurance Contributions Act (social security taxes) and the Federal Unemployment Tax Act (unemployment taxes).[2]

The exemption extends to the PBGC both in its corporate capacity and in its capacity as a trustee for terminated retirement plans. The exemption extends to the corporation's property, franchise, capital reserves, surplus, and to its income. The exempt income includes, of course, the income earned by corporate investments out of premium payments and income earned by plans for which the PBGC is acting as a fiduciary.

Effective date

The exemption applies from September 2, 1974 (the date of enactment of ERISA).

Revenue effect

This provision is expected to have no effect on revenue.

11. Level Premium Plans Covering Owner-Employees (sec. 1511 of the Act and sec. 415(c) of the Code)

Prior law

An owner-employee covered by an H.R. 10 plan can contribute each year an amount in excess of the general H.R. 10 percentage limit (15

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[1] As a practical matter, the PBGC's Federal income tax liabilities would have been primarily on account of premiums paid for plan termination insurance coverage and investment income earned on these premiums, as well as on account of the investment income earned through the operation of terminated plans in the PBGC's fiduciary capacity.

[2] Imposed under chapters 21 and 23, respectively, of the Code.

percent of earned income) to a plan funded with level premium annuity contracts, if the fixed premium does not exceed $7,500 and does not exceed the owner-employee's three-year average of deductible amounts. The amount in excess of 15 percent of the owner-employee's earned income is not deductible. Under prior law, a separate provision for all qualified plans, including level premium H.R. 10 plans, limited contributions to 25 percent of earned income.

Reasons for change

The 25-percent overall limitation frustrated the H.R. 10 plan provisions regarding level premium annuity contracts which would otherwise have permitted nondeductible plan contributions to be made even though they exceeded 15 percent of the owner-employee's earned income. The Congress was concerned that if the 25-percent rule had not been modified, many H.R. 10 plans would not have been able to continue in their present form.

Explanation of provision

The Act allows an owner-employee to make level payments to an H.R. 10 plan under the 3-year-averaging rules for annuity contracts under an H.R. 10 plan without regard to the overall 25 percent limitation. The Act also adds rules regarding the treatment of contributions under the anti-discrimination rules applicable to pension plans.

Under the provision, no other amounts can be added to the owner-employee's account for the year under any other defined contribution plan or tax-sheltered annuity maintained by the employer or a related employer, and the employee may not be an active participant for the year in a defined benefit plan maintained by the employer or a related employer. However, the Act does not change the overall limitations which apply where an employee participates in both a defined contribution plan and a defined benefit plan.

Effective date

The rule applies for years beginning after December 31, 1975 (the effective date of the overall 25-percent limitation).

Revenue effect

This provision is expected to decrease revenues by a negligible amount.

12. Lump-Sum Distributions from Pension Plans (sec. 1512 of the Act and sec. 402(e)(4) of the Code)

Prior law

Under the law as amended by the Employee Retirement Income Security Act of 1974, the part of a lump-sum distribution earned before 1974 is treated as capital gain and the post-1973 part is taxed, if the taxpayer elects, as ordinary income in a "separate basket", with 10-year income averaging. If the election is not made, the post-1973 part of the distribution is taxed as ordinary income under the usual rules.

Reasons for change

In 1974, the Congress provided for a phase-out of capital gains treatment for lump-sum distributions and for a phase-in of ordinary income treatment with 10-year income averaging. However, because of the changes made by this Act (Sec. 301) in the minimum tax provisions, which reduce the taxpayer's preference income exemption and increase the rate of minimum tax on all preference income, including the capital gains portion of a lump-sum distribution, the tax on a lump-sum distribution which is treated as capital gain income could be greater than if the entire distribution were treated as ordinary income subject to the 10-year averaging provisions.

Both capital gains treatment and the 10-year averaging rules are intended to provide relief where large pension distributions, earned over a period of years, are received in a single year. These distributions are made to low paid employees as well as high paid employees and the Congress concluded that where capital gains treatment creates a burden instead of relief, it is appropriate to allow a taxpayer to elect to treat a distribution as ordinary income rather than capital gains.

Explanation of provision

Under the Act, a taxpayer who has not treated any part of a post-1975 lump-sum distribution as capital gains may irrevocably elect to treat all post-1975 lump-sum distributions as if they were earned after 1973, so that they will be taxed as ordinary income and will qualify for 10-year income averaging.

Effective date

The election applies to distributions made after 1975 in taxable years beginning after December 31, 1975.

Revenue effect

This provision is expected to decrease revenue by $10 million annually in fiscal 1977 and 1978, by $9 million annually in fiscal 1979 and 1980, and by $8 million in fiscal 1981.

O. REAL ESTATE INVESTMENT TRUSTS

Prior law

Real estate investment trusts ("REITs") are provided with the same general conduit treatment that is applied to mutual funds. Therefore, if a trust meets the qualifications for REIT status, the income of the REIT which is distributed to the investors each year generally is taxed to them without being subjected to a tax at the REIT level (the REIT being subject to tax only on the income which it retains and on certain income from property which qualifies as foreclosure property). Thus, the REIT serves as a means whereby numerous small investors can have a practical opportunity to invest in the real estate field. This allows these smaller investors to invest in real estate assets under professional management and allows them to spread the risk of loss by the greater diversification of investment which can be secured through the means of collectively financing projects.

In order to qualify for conduit treatment, a REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow the special tax treatment for a REIT only if there really is a pooling of investment arrangement which is evidenced by its organizational structure, if its investments are basically in the real estate field, and if its income is clearly passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the income of the REIT must be passed through to its shareholders on a current basis.

With respect to the organizational structure, a REIT, under prior law, had to be an unincorporated trust or association (which would be taxable as a corporation but for the REIT provisions) managed by one or more trustees, the beneficial ownership of which was evidenced by transferable shares or certificates of ownership held by 100 or more persons, and which would not be a personal holding company even if all its adjusted gross income constituted personal holding company income.

With respect to the income requirements, at least 75 percent of the income of the REIT had to be from rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (or interests therein, including mortgages), distributions from other REITs, gain from the disposition of shares of other REITs, abatements or refunds of taxes on real property and income and gain derived from property which qualifies as foreclosure property. An additional 15 percent of the REIT's income had to come from these sources, or from other interest, dividends, or gains from the sale of stock or securities. Income from the sale or other disposition of stock or securities held less than 6 months, or real property held less than 4 years (except in the case of involuntary conversions), had to be less than 30 percent of the REIT's income.

With respect to the asset requirements, at the close of each quarter of its taxable year, a REIT had to have at least 75 percent of the value of its assets in real estate, cash and cash items, and Government securities. Furthermore, not more than 5 percent of the REIT's assets can be in securities of any one nongovernment-non REIT issuer, and such holdings may not exceed 10 percent of the outstanding voting securities of such issuer. Also, no property of the REIT, other than foreclosure property, may be held primarily for sale to customers.

In addition, a REIT is required to distribute at least 90 percent of its income (other than capital gains income, and certain net income from foreclosure property less the tax imposed on such income by section 857) to its shareholders during the taxable year or, under certain circumstances, the following taxable year.

If all of these conditions are met, then the REIT generally is qualified for the special conduit treatment which allows the income that is distributed to the shareholders to be taxed to them without being subjected to a tax at the trust level, so that the REIT is only taxed on the undistributed income and certain income from foreclosure property. A REIT that does not meet the requirements for qualification would be taxed as a regular corporation.

Reasons for change

Although the provisions have been amended from time to time, until 1974 the basic rules with respect to REITs have remained the same since their enactment in 1960. Since 1960, the REIT industry has grown enormously in size and is responsible for a large portion of the investment in the real estate field in the United States today. There are, however, certain problems that have arisen with respect to the REIT provisions which could significantly affect the industry if these provisions are not modified.

In 1974, as part of Public Law 93–625, the Congress dealt with one of these problems, i.e., the difficulty which a REIT may have in meeting the income and asset tests if it must foreclose on a mortgage that it owns or reacquire property which it owns and has leased. Under that Act, in general, a REIT is not disqualified because of income it receives from foreclosure property, since acquisition of property on foreclosure generally is inadvertent on the part of the mortgagee. At the election of a REIT, a two-year grace period (generally subject to two one-year extensions) is allowed so that the REIT can liquidate the foreclosed property in an orderly manner or negotiate changes, (*e.g.*, in leases on the property) so that income from the property becomes qualified. However, during the grace period the REIT must pay the corporate tax on the otherwise nonqualified income received from property acquired on foreclosure.

Certain other problems remained in this area, however. Basically, these problems related to the fact that, under prior law, if a REIT did not meet the various income, asset, and distribution tests, the REIT would be disqualified from using the special tax provisions even in cases where the failure to meet a test occurred after a good faith, reasonable effort on the part of the REIT to comply. Disqualification would have the effect of not only changing the tax status of the REIT itself, subjecting its income to tax at corporate rates, but also could adversely affect the interests of the public shareholders of the REIT. The Congress believed that it is not appropriate to disqualify a REIT in such circumstances.

Explanation of provisions

1. Deficiency Dividend Procedure (sec. 1601 of the Act and sec. 859 of the Code)

As described above, to qualify as a REIT a trust must operate as a conduit for the income it earns, distributing at least 90 percent [1] of its annual income to its shareholders. However, under prior law, even where a REIT believed in good faith that it has satisfied this test. it could be disqualified as a result of an audit by the Internal Revenue Service which increased the amount of income that forms the base for the 90-percent distribution requirement. For example, a REIT's depreciation allowance for an asset may be unclear (e.g., because of a problem in determining the useful life of an asset or in allocating the cost of rental property between land and improvements) and the depreciation taken by the REIT may be determined to be too high by the Internal Revenue Service in a subsequent year. In such a case, the REIT would have lost its qualification if its real estate investment trust taxable income was increased to such an extent that its previous dividend distributions for the year in question became less than 90 percent of its real estate investment trust taxable income as determined after audit. On disqualification as a REIT, the trust would have been subject to tax as any other corporation, even though it previously may have distributed most of its income for the year in question to its shareholders.

The Congress believed that where a REIT originally acted without fraud in determining and reporting its income and dividend distributions, the sanction of disqualification was too severe. For this reason, the Congress believed that if a REIT is audited by the Internal Revenue Service and there is a resulting adjustment that would increase the amount of dividends that must be paid for the year under audit for the trust to meet the 90-percent distribution requirement, the trust should be allowed to pay out deficiency dividends to its shareholders and thereby avoid disqualification. This deficiency dividend procedure is only to be available where failure of the REIT to meet the 90 percent distribution requirement was not due to fraud with intent to evade tax or to willful failure to file an income tax return within the required time.

The Act provides that where, as a consequence of an audit by the Internal Revenue Service, there has been a "determination" that an adjustment is to be made, the trust may pay a deficiency dividend to its shareholders and receive a deduction for such distributions. If the proper amount is distributed as a deficiency dividend, the REIT would

[1] As described below, the Act increases the distribution requirement to 95 percent for taxable years beginning after December 1, 1979. In this explanation, the requirement is referred to as the "90-percent distribution requirement".

not be disqualified or be subject to tax on the amounts distributed (other than interest and penalties, as described below).[2]

For these purposes, an "adjustment", which will allow a REIT to follow the deficiency dividend procedure, is defined under the Act to include an increase in the sum of the REIT's real estate investment trust taxable income (determined without regard to the deduction for dividends paid) and the net after-tax income from foreclosure property. An "adjustment" also is defined to include any decrease in the deduction for dividends paid (determined without regard to capital gains dividends). Any change on audit in these amounts either may increase the amount of dividends that must be paid to meet the 90-percent distribution requirement or may decrease the amount of dividends previously thought to have been paid, affecting the ability of the REIT to meet the distribution requirement.[3]

Such an increase in income, etc., need not cause the REIT to fail the 90-percent distribution requirement for the deficiency dividend procedure to be available. The deficiency dividend procedure also is to be available to enable a trust to maintain the level of distribution that it originally had thought it had achieved. On the other hand, a deficiency dividend cannot exceed the net adjustment that occurs on audit.

For example, assume that a REIT reported real estate investment trust taxable income of $100 for the year, and had distributed dividends of $90 with regard to that year, but on audit it was determined that the REIT had $110 of real estate investment trust taxable income for that year. In this case, the REIT could pay a deficiency dividend of up to $10, which is the amount of the adjustment, though only a $9 deficiency dividend would be required to enable the REIT to meet the income distribution requirements for that year. Thus, the REIT could pay a deficiency dividend sufficiently large so it would not have to pay any additional corporate income tax (as opposed to interest and penalties) as a result of the determination. However, the REIT could not receive a deficiency dividend deduction for $11 since this is greater than the amount of the adjustment and would decrease the corporate tax previously paid on the $10 originally reported and treated as taxable.[4]

Capital gains.—A REIT is required to pay a capital gains tax on any excess of net long-term capital gains over the sum of net short-term capital loss and the deduction for capital gains dividends paid to its shareholders. Capital gains dividends must be designated as such within 30 days after the close of the taxable year in which the income

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[2] Following the personal holding company provisions of present law, the Act provides that a "determination" is to be a decision by the Tax Court (or order by any other court of competent jurisdiction) which has become final, a closing agreement under section 7121, or an agreement (under regulations) between the Internal Revenue Service and the trust regarding the liability of the trust for tax.

[3] In addition, if on audit it is determined that there is an increase in the net long-term capital gains over net short-term capital loss and over the deduction for capital gains dividends, this increase will be an adjustment for purposes of the capital gains rules of the REIT provisions, as discussed below.

[4] Also, if this REIT had originally paid out a dividend of $99, it would be able to pay a deficiency dividend of up to $10, for a total distribution of up to $109. In this way, the REIT would not be subject to tax on additional income determined on audit. However, in this case, the REIT would not have to pay any deficiency dividend to avoid disqualification since it still would have met the 90-percent distribution requirement even after the adjustment and, therefore, may chose not to pay any additional amounts under the deficiency dividend procedure.

is recognized. Consequently, under prior law, if it were determined on audit that a REIT had additional capital gains, the REIT would not be able to make a timely designation of a capital gains dividend, distribute this income, and avoid paying capital gains tax. Also, even if the REIT had previously reported this income as ordinary income and distributed 90 percent of it as dividends to shareholders, the REIT still was subject to capital gains tax on this amount upon a determination that the income was capital gains (since a timely designation of capital gains dividends could not be made).

To correct this situation, the Act provides that an "adjustment" which will allow the deficiency dividend procedure to be used is to include an increase (by a determination) in the excess of the net long-term capital gains over the sum of the net short-term capital loss and the deduction for capital gains dividends paid. Therefore, if net long-term capital gains are increased as the result of an audit, the REIT can choose to distribute up to the amount of this increase to its shareholders and avoid paying capital gains tax on this amount. Also, if the REIT had originally reported this amount as ordinary income and previously had made a timely distribution of this income, the REIT is to be able to redesignate the previous distribution as a capital gains distribution and avoid paying the capital gains tax.

Where there is a redesignation of a prior distribution as either ordinary income or capital gain, the shareholder is required to recompute his tax accordingly so long as the statute of limitations has not expired for that shareholder. In addition, the Act provides that the deficiency dividend will be treated as a dividend by both the trust and the shareholder even though the trust does not have sufficient earnings and profits at the time of the distribution.

Fraud.—Under the Act, the deficiency dividend deduction is to be available only if the entire amount of the adjustment was not due to fraud with intent to evade tax or to willful failure to file an income tax return within the required time. The question of whether the failure to meet the dividend distribution requirement is due to fraud will depend on all the facts and circumstances.

Interest and Penalties.—The interest and penalty provisions of the Act with respect to deficiency dividends are designed to recover lost revenues to the government as well as to assure that a REIT (1) will be operated as a conduit of income to its shareholders and (2) will not reduce its distributions of income in reliance on the availability of the deficiency dividend procedure. Under the Act, interest and penalties are determined with respect to the amount of the adjustment,[5] but only to the extent that the deficiency dividend deduction is allowed. For example, assume that the REIT's real estate investment trust taxable income was reported at $100, that the REIT had distributed $98, and that after audit it was determined that the correct amount of real estate investment trust taxable income was $120 so that the REITshould have distributed at least $108. If the REIT utilizes the deficiency divided procedure and distributes an additional $10, the interest and penalty

[5] For this purpose, the amount of the adjustment would include adjustments attributable both to ordinary income and capital gains. However, no interest and penalty are assessed in the event of the late designation of a capital gains dividend where the amount was distributed previously as an ordinary income distribution.

will be based upon $10, the amount for which a deficiency dividend deduction is allowed.

By using the amount of the deficiency dividend as the base, the Act assures that the net cost to the REIT of borrowing money from its shareholders (that is, the net cost of underdistributions) is high enough to discourage such action and to encourage the distribution of earnings to shareholders currently.

Under the Act, interest on the amount of the deficiency dividend is to run from the last day (without extension of time) for the REIT to file a tax return for the year in question until the date the claim for the deficiency dividend deduction is filed. In addition, a nondeductible penalty equal to the amount of interest is to be paid. However, the total penalty is not to exceed one-half the amount of the deficiency dividend deduction.[6] Under the Act, the (deductible) interest charge is to be the same as in the case of other deficiencies and the penalty is to be the same amount, for an approximate net-after-tax total (under current interest rates) of 10½ percent of the deficiency dividend deduction per annum.

Effect on other years.—The Act provides that the amount of the deficiency dividend is taxable to the shareholder for the shareholder's taxable year *in* which the distribution is made (not the year *for* which it is made). For example, if a shareholder receives a deficiency dividend in 1980, with respect to the year 1977, this dividend is includible in income for 1980, and shareholders are not to file amended returns for 1977 to take account of the dividend. It is expected that, in this case, the deficiency dividend will be paid to the 1980 shareholders, even if they were not shareholders in 1977.

To avoid double counting, deficiency dividends are not to count toward the dividends paid deduction for the year in which the deficiency dividends are actually paid, but are only to count toward the year affected by the determination. Also, deficiency dividends are not to count toward the dividend deduction (under section 858) for the taxable year preceding the year of payment. For example, if $10 of deficiency dividends are paid in 1980 on account of a determination involving the year 1977, the deficiency dividends are not to count toward the dividends paid deduction for 1980 or for 1979, but are to be treated only as dividends paid with respect to 1977.

Technical requirements.—For the deficiency dividend deduction to be available, the trust must pay the deficiency dividend to its shareholders within 90 days after the determination. To qualify as a deficiency dividend, the dividends paid must be of the same type that would qualify for the dividends paid deduction under section 561, if they had been distributed during the taxable year in issue. Also, the trust must (under regulations) file a claim for the deduction within 120 days after the determination. (These provisions are similar to the provisions of existing law with respect to personal holding company deficiency dividends.)

Under the Act, a REIT will have two years after the date of a determination to file a claim for refund for the taxable year in issue

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[6] Under the Act payment of the penalty portion decreases the base for the 90-percent distribution requirement in the year the interest and penalty are paid. The interest portion is automatically taken into account in computing the base since it is deductible.

where allowance of a deficiency dividend results in an overpayment of tax. Also, if a REIT files a claim for a deficiency dividend deduction, the running of the period of limitations for making assessments, bringing a suit for collection, etc., is to be suspended for two years after the date of the determination.

Where there is a determination of a deficiency under these provisions, collection, interest, penalties, etc., are to be stayed for 120 days after the determination (except in cases of jeopardy). Also, as in the case of deficiency dividends paid by a personal holding company, if a claim for a deficiency dividend deduction is filed, collection of the remaining deficiency is to be stayed until the claim is disallowed.

Increase in distribution requirement.—Since the deficiency dividend procedure will eliminate the risk of inadvertent disqualification through failure to meet the distribution test, the Act increases the portion of its income which a REIT must distribute from 90 to 95 percent for taxable years ending after December 31, 1979. The Congress believes it is appropriate to delay the effective date of this increase in order to allow REITs which may have restrictions in their credit agreements relating to dividend distributions an opportunity to negotiate modifications of such agreements.

2. Distributions of REIT Taxable Income After Close of Taxable Year (secs. 1604 and 1605 of the Act and secs. 858, 860, 4981 of the Code)

Excise tax on REIT taxable income not distributed during the taxable year.—Under prior law, a REIT was required to declare a dividend for a taxable year by the due date for filing the return for that year, but the REIT could delay actual payment of the dividend for 12 months after the close of the taxable year. For example, if a REIT were on a calendar year basis, dividends for 1973 did not have to be paid until December 31, 1974. (These dividends are hereafter called "section 858 dividends" since a deduction with respect to such dividends is allowed under section 858 of the Code.)

In general, the policy underlying the conduit treatment of REITs is that either the REIT or its shareholders will be currently taxable on the income earned by the REIT. But this policy was not fulfilled where there was a substantial use of section 858 dividends by the REIT prior to distribution because no charge was imposed for the one-year delay in payment of the dividend even though, during this year, neither the REIT nor its shareholders are liable for tax on the REIT income. Through a repeated use of the section 858 dividends procedure, there could be a permanent loss of revenue (a permanent one-year delay).

To meet this situation, the Act establishes an excise tax on late distributions of income in order to prevent this loss of revenue to the Treasury. In order to avoid the excise tax, a REIT is required to distribute at least 75 percent of its real estate investment trust taxable income as reported on its return by the close of its taxable year. If, by the end of its taxable year, the REIT has distributed less than 75 percent of its real estate investment trust taxable income (as reported on its return), it is to be subject to a nondeductible 3 percent excise tax on the difference between 75 percent of this income and the amount distributed. For example, if a REIT reports real estate investment trust taxable income of $100 for taxable year 1980 and distributes $70 of dividends by the end of this taxable year, it will be subject to a nondeductible 3 percent excise tax on $5, which is the amount by which the distribution falls short of 75 percent by the end of the taxable year.[1] The 3-percent charge is to be a one-time charge without regard to the date of the later distribution. (However, the REIT must meet the 90-percent distribution test within 12 months after the close of the taxable year in question if the trust is to qualify as a REIT.) This 3-percent excise tax is to apply to taxable years beginning after December 31, 1979.

Adoption of annual accounting period.—If a REIT's shareholders are on the calendar year for reporting income and the REIT is on a fiscal year, the REIT, by waiting until the end of its year to distribute income to its shareholders, in many circumstances could allow its shareholders a two-year delay in reporting this income. To avoid a potential two-year delay in revenue in the future, the Act provides that a REIT is not to adopt in the future (or change to in the future) any annual accounting period other than the calendar year.

Dividends paid by REIT after close of taxable year.—Under prior law, a REIT could, to a substantial extent, avoid an underdistribution of a prior year's income if it made a "contingent" section 858 election. Such a "contingent" election was made when the REIT elected to have a dividend relate to a prior year only to the extent to which earnings and profits from that prior year remain undistributed. Thus, by declaring a section 858 dividend, a REIT could be "covered" for two years. This may have been needed under prior law where there was no deficiency dividend procedure. However, this is no longer necessary or appropriate with the deficiency dividend procedures established by the Act. Moreover, this rather loose accounting procedure facilitated the possibility that a REIT could delay distribution of its income to its shareholders, and thus delay the date on which shareholders must include such dividends in income.

With the new deficiency dividend procedure provided by the Act, it is inappropriate to continue the use of section 858 dividends as a way to avoid problems from an underdistribution of a prior year's income. Consequently, the Act amends section 858 to explicitly provide that the amount allowed as a section 858 dividend is to relate *only* to the prior taxable year and is not in any event also to relate to the taxable year in which the dividend is paid. Also, under the Act, a section 858 dividend is to be stated in a dollar amount. The amount so stated is to be the only amount of dividends paid during the year of payment which relates to the prior year, and that amount is to be a dividend only for the prior year and not for the year in which paid.

For example, in 1977 a REIT with a calendar taxable year has $100 of real estate investment trust taxable income and pays a dividend of $75 in 1978. In order to meet its 90-percent distribution requirement for 1977, the REIT declares and pays $15 as a section 858 dividend.

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[1] Amounts counted toward the 75-percent requirement are only to be amounts that qualify for the dividends paid deduction for the current year. Therefore, any section 858 dividends or deficiency dividends (which are to relate only to a prior year) are not to be counted toward this 75-percent requirement.

For the dividend to qualify under section 858, the REIT must specify that the dividend is a section 858 dividend for 1977 and that it is in the amount of $15. This amount, then, is to relate only to 1977 and not to 1978. The excise tax is effective only after December 31, 1979. In 1978, the REIT also has $100 real estate investment trust taxable income. To avoid paying the excise tax on late distributions for 1978, the REIT must distribute $75 in 1978. Therefore, in 1978, the REIT would have to distribute $15 (as a section 858 dividend for 1977) plus $75 (as a dividend for 1978) for a total of $90 actually paid as dividends in 1978 in order to meet its 90-percent distribution requirements for 1977.

3. Property Held for Sale (sec. 1603 of the Act and secs. 856 and 857 of the Code)

Prior law prohibited a REIT from holding property, other than property qualifying as foreclosure property, for sale to customers. This rule was difficult to apply because of the absolute prohibition on holding such property and because of problems involved in determining when a REIT holds property for sale.

Because of these problems, the Act eliminates the flat prohibition against a REIT holding property primarily for sale to customers in the ordinary course of its trade or business. Under the Act, the sale or other disposition of property described in section 1221(1) of the Code is called as a prohibited transaction and the net income from such transactions is taxed at a rate of 100 percent. Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses and other deductions allowed by chapter 1 of the Code which are directly connected with the sale or other disposition of such property. Thus, for example, if a REIT sells two items of property described in section 1221(1) (other than foreclosure property) and recognizes a gain of $100 on the sale of one item and a loss of $40 on the sale of the second item (and has no other deductions directly connected with prohibited transactions), the net income from prohibited transactions will be $60. Deductions directly connected with prohibited transactions are those deductions, otherwise allowed by chapter 1 of the Code, which are proximately and primarily connected with such transactions. (General overhead costs, for example, may not be allocated to income from prohibited transactions.)

Under the Act, since a separate tax is applied to net gain from prohibited transactions, net gain (or net loss) from prohibited transactions is not taken into account in determining real estate investment trust taxable income.[1]

The 100-percent tax on net income from prohibited transactions is included in the Act to prevent a REIT from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. One transaction in particular where questions have been raised is whether a REIT holds

[1] However, to prevent a REIT which has incurred a net loss on prohibited transactions from having to deplete capital in order to meet the 90-percent distribution requirement, the amount of income which must be distributed to satisfy that requirement is to be reduced by the amount of any net loss from prohibited transactions.

property for sale where it enters into a purchase and leaseback of real property with an option in the seller-lessee to repurchase the property at the end of the lease period. Such a transaction frequently is a normal method of financing real estate and is used in lieu of a mortgage. The Congress intends that with respect to the real estate investment trust provisions, income from a sale under an option in this type of transaction is not to be considered as income from property held for sale solely because the purchase and leaseback was entered into with an option in the seller to repurchase and because the option was exercised pursuant to its terms. However, other facts and circumstances might indicate that income from the transactions described above would be income from prohibited transactions. In determining whether a particular transaction constitutes a prohibited transaction, a REIT's activities with respect to foreclosure property and its sales of such property should be disregarded. The Congress intends that no inference regarding these type of transactions is to be drawn for any other purpose of the tax laws because of this treatment with respect to real estate investment trusts.

4. Failure to Meet Income Source Tests (sec. 1602 of the Act and secs. 856 and 857 of the Code)

Certain percentages of a REIT's income must be from designated sources for the REIT to receive conduit tax treatment. If the source tests (that is, the 75 percent or 90 [1] percent income source tests decribed above) were not met, under prior law, the REIT was disqualified and paid taxes on its income as if it were a regular corporation. This could cause hardship for a REIT which reasonably and in good faith believed it met the income source tests and distributed substantially all of its income to its shareholders, but which did not meet one of these tests and was required to pay tax at regular corporate rates. The Congress believes that, in this situation, the REIT should not be disqualified but should be required to pay a 100-percent tax on the net income attributable to the amount by which it fails to meet the income source tests.

Accordingly, the Act provides that, where the trust fails to meet either the 75-percent or 90-percent income source test, the REIT will not be disqualified if it (1) sets forth the nature and amount of its gross income qualifying for such tests in a schedule attached to its income tax return, (2) the inclusion of any incorrect information in this schedule is not due to fraud with an intent to evade tax,[2] and (3) the failure to meet the income source requirement is due to reasonable cause and not due to willful neglect.

The failure to meet an income source test will be due to reasonable cause and not due to willful neglect if the REIT exercised ordinary business care and prudence in attempting to satisfy the tests. Such care and prudence must be exercised at the time each transaction is

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[1] As described below, the Act increases the 90-percent source of income requirement to 95 percent for taxable years beginning after December 31, 1979. In this explanation, the requirement is referred to as the 90-percent income source test.

[2] Under this provision, a REIT may commit fraud with intent to evade tax even though it has a net loss and thus no tax liability for the year in question. This could occur where a REIT with a net loss fraudulently indicated on the schedule that it had satisfied the gross income tests so that it could avoid being disqualified for the 5-year period provided under the Act.

entered into by the REIT. However, even if the REIT exercised ordinary business care and prudence in entering into a transaction, if it is later determined that the transaction is producing nonqualified income in amounts which, in the context of the REIT's over-all portfolio, could cause an income source test to be failed, the REIT must use ordinary business care and prudence in an effort to renegotiate the terms of the transaction, or alter other elements of its portfolio. In any case, failure to meet an income source test will be due to willful neglect and not reasonable cause if the failure is willful. For example, if a REIT willfully fails an income source test for a legitimate business purpose, such failure is nonetheless due to willful neglect.

Under the Act, in lieu of disqualification, a 100-percent tax is imposed on the net income attributable to the greater of the amount by which the REIT failed the 90-percent test or the 75-percent test. To determine such net income, the amount by which the respective test is failed is multiplied by a fraction which reflects the average profitability of the REIT. The numerator of the fraction is real estate investment trust taxable income for the year in question (determined without regard to deductions for certain taxes and net operating losses, and by excluding certain capital gains). The denominator of the fraction is the gross income of the REIT for the year in question (determined without regard to gross income from prohibited transactions, certain gross income from foreclosure property, and certain capital gains and losses). This fraction provides a simplified way to determine the net income of the REIT from the nonqualifying income in question without requiring an apportionment or allocation of specific deductions or expenses.

It is not necessary that the schedule attached to the return referred to above indicate that the REIT has in fact satisfied income source tests. However, the 100-percent tax will not apply and REIT will be disqualified if the REIT does not meet the income source tests and the inclusion of any incorrect evidence in the schedule is due to fraud with an intent to evade tax.

It is the Congress' intention that the schedule which the REIT must attach to its return to avoid disqualification contain a breakdown, or listing, of the total amount of gross income falling under each of the separate subparagraphs of section 856(c) (2) and (3). Thus, for example, it is intended that the REIT, for purposes of listing its income from sources described in section 856(c)(2), would list separately the total amount of dividends, the total amount of interest, the total amount of rents from real property, etc. It is not the intention of the Congress that the listing be on a lease-by-lease, loan-by-loan, or project-by-project basis. It is expected, however, that the REIT will maintain adequate records with which to substantiate the total amounts listed in the schedule upon audit by the Internal Revenue Service.

5. Other Changes in Limitations and Requirements (secs. 1604, 1606–7 of the Act and sec. 856 of the Code)

95-percent income source test.—Under prior law, 10 percent of a REIT's gross income could be from nonqualified sources. However, the provisions of the Act, as discussed below, remove a significant portion of income customarily received by REITs from the category of nonqualified income. In addition, under other provisions of the Act, discussed above, a REIT is no longer automatically disqualified where it fails to satisfy the income source tests, so there is less need to allow a REIT to have such income as a hedge against inadvertent disqualification. Consequently, the Act increases the 90-percent income source test to 95 percent, so that, generally, nonqualified income may not exceed 5 percent of gross income. The Act, however, delays the effective date until taxable years beginning after December 31, 1979, in order to give REITs an opportunity to negotiate modifications of existing arrangements which may be producing nonqualified income. For purposes of this test, as well as the 75-percent income source test, the Act excludes gain from prohibited transactions from a REIT's total gross income as well as from gross income qualifying for the income tests.

Inclusion in qualified income of charges for customary services.—Generally, under prior law, amounts received by a REIT for services rendered to tenants, where no separate charge is made, would have qualified for the 75-percent and 90-percent source tests if the services were customary and furnished by an independent contractor. However, if a separate charge was made for customary services furnished by an independent contractor, the income tax regulations took the position that the amount of the charge must be received and retained by the independent contractor and not by the REIT. This restriction on separate charges for customarily furnished services often did not follow normal commercial practice. Consequently, the Act provides that amounts received by a REIT as charges for services customarily furnished or rendered in connection with the rental of real property will be treated as rents from real property whether or not the charges are separately stated. The Congress intends that, with respect to any particular building, services provided to tenants should be regarded as customary if, in the geographic market within which the building is located, tenants in buildings which are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. Also, in those situations where it is customary to furnish electricity to tenants, the Congress intends that the submetering of electricity to tenants be regarded as a customary service.

Inclusion in qualified income of rent from incidental personal property.—Generally, under prior law, where an amount of rent is received with respect to property which consists of both real and personal property, such as a furnished apartment building, an apportionment of the rent was required. Only that part of the rent which was attributable to real property was treated as qualifying income for purposes of the income source tests.

The Congress believes that where rents attributable to such personal property are an insubstantial amount of the total rents received or accrued under a lease covering both real and personal property, the rents should be treated as qualified income. Thus, the Act provides that rents attribuable to personal property which is leased under, or in connection with, the lease of real property will be treated as rents from real property (and thus qualified for purposes of the income source tests) if the rent attributable to the personal property is not more than 15 percent of the total rent for the year under the lease.

Under the Act, the 15-percent test is to be examined for each lease of real property. For each lease, the rent attributable to personal property is that portion of the total rent under the lease for the year determined by multiplying total rent times a fraction; the numerator of the fraction is the average of the adjusted basis of the personal property at the beginning and at the end of the taxable year; the denominator of the fraction is the average of the aggregate adjusted bases of both the real property and personal property at the beginning and at the end of the taxable year. If the rent attributable to personal property under this formula is greater than 15 percent of the total rent under the lease, then all rent attributable to personal property from the lease will be treated as nonqualifying income. In order to provide for ease of administration, the Congress believes it would be appropriate for a REIT which rents units in a multiple unit project under substantially similar leases (for example, an apartment building) to apply the apportionment test on the basis of the project as a whole.

A similar problem of allocation existed with respect to interest on obligations secured by real property. While the Congress believes a *de minimis* rule in this area is also appropriate, the Act does not provide such a rule since the Treasury Department has indicated through the publication of proposed regulations that the issue can be resolved administratively.

Inclusion in qualified income of commitment fees.—Under prior law, compensation received for an agreement to lend money where the loan is secured by real property, or received in connection with a purchase or lease of real property, was not treated as qualifying income for the income source tests. Since these fees are often part of the lending activities of a real estate investment trust and are essentially passive in nature, the Act includes such fees as qualifying income for purposes of the 75-percent and 90-percent income source tests. The Act, however, is not intended to alter the law with respect to whether such fees constitute income. For example, a fee received for agreeing to purchase real property does not constitute income unless and until the right to require the purchase expires unexercised; if such right is exercised, the fee results in a basis adjustment.

Inclusion in qualifying assets of options to purchase real property.—Under prior law, it was not clear whether options to purchase real property constitute qualified assets for purposes of the 75-percent asset test nor was it clear whether gain from the sale of options on real property was qualified income for purposes of the 75-percent income test. Since investment in options to acquire real property may be important in the operations of a real estate investment trust, such options are treated under the Act as "interests in real property" for purposes of these tests.

Use of corporate form.—Under prior law, a real estate investment trust could only be an unincorporated trust or unincorporated association. The Congress understands that this requirement caused operating problems for some REITs under State law. Consequently, the Act provides that REITs are to be permitted to operate in corporate form. However, the Act makes clear that banks and insurance companies, which typically are engaged in other nonpassive activities, cannot qualify as REITs under these provisions.

30-percent income test.—Since the Act permits REITSs to have income from the sale or other disposition of property held for sale to customers, the 30-percent income test is amended by the Act to include income from the sale of such property (not including foreclosure property). In addition, the 30-percent test is amended to include income from the sale of interests in mortgages on real property held for less than four years as well as other interests in real property.

Definition of "interest" for income source tests.—Following present law with respect to rents, the Act provides that "interest" does not include any amount which depends, in whole or in part, on the income or profits of any person. This is part of the overall requirement that a REIT be a passive investor and not participate in active business through a profit participation.

As in the case of contingent rents (discussed below), however, the Act provides that where a REIT receives amounts which would be excluded from the term "interest" solely because the debtor of the REIT receives amounts based on the income or profits of any person, only a proportionate part of the amount received by the REIT will fail to qualify as interest. The Congress believes that the approach described below with respect to the determination of the proportionate part of contingent rents which do not qualify is also a reasonable approach for determining the proportionate part of contingent interest that does not qualify. These interest provisions will apply only with respect to loans made after May 27, 1976. A loan is to be considered as made on or prior to May 27, 1976, if it was made pursuant to a binding commitment entered into on or before that date.

The Congress intends that this provision is to have no effect whatsoever on the definition of the term "interest" for any other purpose.

Contingent rent.—Generally, under prior law, rent received or accrued with respect to real property which is based, in whole or in part, upon the income or profits derived by any person from the leased property does not qualify for the income source tests. On the other hand, rent received or accrued with respect to real property which is based solely upon a fixed percentage or percentages of receipts or sales does qualify for the income source tests. Where a REIT received rent, a portion of which is based on a percentage of its tenant's gross receipts, and the gross receipts of its tenants included amounts based upon income or profits derived by any party from the property, the entire amount of the rent was non-qualifying income (and not just the portion attributable to the income or profit) under prior law. For example, where the REIT leased a shopping center to a prime tenant for a rent which consists of a fixed-dollar amount plus a percentage of the prime tenant's gross receipts and the prime tenant leased one store in the shopping center to a subtenant for a rent which includes a percentage of the subtenant's profits, the entire amount of rent, fixed and contingent, received by the REIT from the prime tenant was nonqualifying income since the rent depended, in part, upon the income or profits derived by a person deriving income from the property (the subtenant). The Congress believes that this rule was unduly harsh since only a portion of the rent received by the REIT was dependent upon the income or profits derived from the property. Moreover, it often is very difficult for a REIT to control the terms of the leases which the prime tenant enters into with its subtenants.

Consequently, the Act contains an amendment under which only a proportionate part of the rent received by a REIT from a prime tenant is nonqualifying income to the REIT where the gross receipts of the prime tenant are based upon the net income of a person derived from the property. The proportionate part is to be determined under regulations to be prescribed by the Secretary of the Treasury.

The Congress believes the following is one reasonable approach which the Secretary of the Treasury may wish to adopt in those regulations. Where a REIT rents property to a prime tenant for a rental which is, in whole or in part, contingent on the receipts or sales of that prime tenant, and the rent which the REIT receives would be non-qualified income solely because the prime tenant receives or accrues from subtenants rent based on the income or profits derived by any person from such property, then the portion of the rent received by the REIT which is non-qualified is to be the lesser of the following two amounts: (a) the contingent rent received by the REIT, or (b) an amount determined by multiplying the total rent which the REIT receives from the prime tenant by a fraction, the numerator of which is the rent received by the prime tenant which is based, in whole or in part, on the income or profits derived by any person from the property and the denominator of which is the total rent received by the prime tenant from the property. For example, assume a REIT owns land underlying a shopping center which it rents to the owner of the shopping center structure for an annual rent of \$10x plus 2 percent of the gross receipts which the prime tenant receives from subtenants which lease space in the shopping center. Assume further that, for the year in question, the prime tenant derives total rent from the shopping center of \$100x and, of that amount, \$25x is received from subtenants whose rent is based, in whole or in part, on the income or profits derived from the property.[1] Accordingly, the REIT will receive contingent rent of \$2x (for a total rent of \$12x). The portion of that rent which is qualified is the lesser of (a) \$2x (the contingent rent received by the REIT), or (b) \$3x (\$12x multiplied by \$25x/\$100x). Accordingly, \$10x of the rent received by the REIT is qualified income and \$2x is nonqualified income.

Net operating loss carryovers.—Under prior law, a REIT was not permitted a net operating loss deduction. However, a REIT which voluntarily disqualified itself as a REIT could carry forward a net operating loss arising in a year for which the trust qualified as a REIT to a year for which the trust did not so qualify and claim a deduction in such year for the loss. As a result, a REIT which incurred a net operating loss could decide to voluntarily disqualify itself in order to use its loss carryover. The Congress believes that a rule which forces a REIT to disqualify itself in order to be allowed a deduction which regular corporations are permitted imposes an unreasonable restriction on REIT status. Consequently, the Act has added a provision which

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[1] It is irrelevant for purposes of this formula whether the reason that rent received by the prime tenant from the subtenant is based, in whole or in part, on income or profits is that (a) the lease between the prime tenant and the subtenant requires the payment of a percentage of profits, or (b) the lease between the prime tenant and the subtenant requires the payment of a percentage of gross receipts and a concession agreement between the subtenant and a concessionaire requires the payment of a percentage of the concessionaire's profits to the subtenant.

permits a net operating loss carryover [2] in computing real estate investment trust taxable income for eight taxable years after the year in which the loss was incurred.

Ordinary loss offsetting capital gains.—Under prior law, a REIT was taxed separately at a flat 30-percent rate on the excess of any net long-term capital gain over the sum of any net short-term capital loss and the deduction for capital gains dividends paid to its shareholders. The alternative tax on capital gains which permits a taxpayer to offset capital gains with ordinary losses, although generally available to corporations, was not available to REITs under prior law. Accordingly, a REIT could not use an ordinary loss incurred during a taxable year to offset its capital gains. As in the case of the operating loss carryovers, this rule had caused some REITs to intentionally disqualify. The Congress believes that REITs should not be treated more harshly than regular corporations in this regard. Consequently, the Act adds an amendment which, in essence, allows ordinary losses to offset the undistributed excess of net long-term capital gains over net short-term capital losses. Under the Act, a REIT will compute its tax on capital gains under two methods and determine its tax under the method which produces the lower tax liability. Under the first method, the tax on the capital gain is any additional tax arising from the inclusion of the excess of net long-term capital gain over net short-term capital loss in the trust's real estate investment trust taxable income. The second method is identical to prior law, that is, a flat 30-percent tax on such undistributed excess capital gain.

Voluntary disqualification.—Under prior law, an election to be taxed as a REIT was irrevocable. If, however, a trust, either intentionally or unintentionally, failed to qualify to be taxed as a REIT for one taxable year, such trust could, nevertheless, requalify to be taxed as a REIT in the next succeeding taxable year. The Congress does not believe it should be necessary for a REIT to contrive to fail one or more tests for qualification in order to terminate its REIT status. Accordingly, the Act provides that a taxpayer may revoke its REIT election after the first taxable year for which the election is effective. The revocation must be made in the manner specified by the Secretary of the Treasury in regulations and must be made on or before the 90th day of the first taxable year for which the revocation is to be effective.

The Congress also believes that since the net operating loss deduction and the alternative tax with respect to capital gains have been made available to REITs, taxpayers should not intentionally switch between REIT and regular corporate status. Accordingly, the Act provides that, if an election as a REIT has been revoked or terminated, the corporation, trust, or association (and any successor) shall not be eligible to make a new election until the fifth taxable year following the year for which the revocation or termination is effective. The five-year disqualification will not apply in the case of a termination, however, if the taxpayer (1) does not willfully fail to file an income tax

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[2] Since REITs receive a deduction for income distributed to their shareholders, it would not be administratively feasible to allow a net operating loss carryback to a year for which the taxpayer was taxable as a REIT, since allowance of a net operating loss carryback might have the effect of recharacterizing as a return of capital amounts distributed as dividends. Accordingly, the Act does not allow a net operating loss to be carried back to a taxable year for which the taxpayer qualifies to be taxed as a REIT.

return, (2) does not commit fraud in its return, and (3) establishes to the satisfaction of the Secretary of the Treasury that the failure to qualify as a REIT was due to reasonable cause and not due to willful neglect.

If a REIT has revoked or terminated its election, the prohibition on making a new election applies with respect to a successor of the REIT. It is the intent of the Congress that similar rules apply for purposes of determining whether a corporation, trust, or association is a successor for purposes of section 856(g)(3) as apply for the purpose of determining under section 1372(f) whether a corporation is a successor to an electing small business corporation.

Effective date

The provisions of the Act that provide for a deficiency dividend procedure are to apply to determinations that occur after the date of enactment (October 4, 1976).

The provisions that provide that a REIT is not to be disqualified in certain cases if it fails to meet the income source tests are to apply to taxable years beginning after October 4, 1976. Also, such provisions are to apply to taxable years of a REIT beginning before October 4, 1976, if, as the result of a determination occurring after October 4, 1976, such trust does not meet the income source requirements for such taxable year. In any case, however, the provisions requiring a schedule to be attached to the income tax return are to apply only to taxable years beginning after October 4, 1976.

The provisions for an alternative tax on capital gains of REITs and a deduction for net operating losses of REITs are to apply to taxable years ending after October 4, 1976. (However, the provision that prohibits the carryback of a loss arising in a year in which the taxpayer qualifies to be taxed as a REIT would prevent such a loss which arose in any taxable year ending after October 4, 1976 from being carried back to any taxable year ending on or before October 4, 1976.)

The provision that a REIT which intentionally disqualifies cannot requalify for five years is to apply to taxable years beginning after October 4, 1976. However, the five-year prohibition on requalification will not apply to a REIT unless it qualifies to be taxed as a REIT for a taxable year ending after October 4, 1976 and subsequently intentionally fails to qualify.

The provisions that eliminate the requirement that a REIT not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business are to apply to taxable years beginning after October 4, 1976. However, if after October 4, 1976, it is determined on audit that a REIT violated the "holding for sale" prohibition for any taxable year ending on or before October 4, 1976, the Act will permit the REIT to elect to have the provisions apply which prevent disqualification but which instead impose a 100-percent tax on net income from prohibited transactions.

All other provisions of the Act relating to REITs apply to taxable years beginning after October 4, 1976.

Revenue effect

These provisions are estimated not to have any significant revenue effect.

P. RAILROAD AND AIRLINE PROVISIONS

1. Treatment of Certain Railroad Ties (sec. 1701(a) of the Act and sec. 263 of the Code)

Prior law

Business taxpayers in general are required to capitalize improvements and betterments to business and productive assets and are generally allowed to recover these costs through depreciation. The railroad industry, however, generally uses for tax purposes what is called the "retirement-replacement" method of accounting for railroad track (rail) and ties, and other items in the track accounts.

For assets accounted for under the retirement-replacement method, when new track is laid, the costs (both materials and labor) of the track and ties are capitalized. No depreciation is claimed on the original installation, but these original costs may be written off if the track is retired or abandoned. If the original installation is replaced with track or ties of a like kind or quality, the costs of the replacements (both materials and labor) are deducted as current expense. This rule applies, for example, when wood crossties are replaced with new wood ties. When the replacement is of an improved quality, it is treated as a betterment, under which the betterment portion of the replacement is capitalized and the remainder is expensed.

A replacement with a different or improved type or kind of track or tie is, on the other hand, treated as a retirement and substitution. Under prior law, for example, when existing wood railroad ties were replaced with concrete ties, the Service held (in Rev. Rul. 68–418, 1968–2 Cum. Bull. 115) that this replacement constituted a retirement and substitution. As a result, the material and labor costs for the new concrete ties were capitalized and the costs of the old wood ties were removed from the asset account and expensed. The same treatment applied where wood ties were replaced by ties made of steel, plastic, wood laminate, or other substitute materials of a different or improved type and kind.

Reasons for change

American railroads have traditionally used crossties made of hardwood timber. During some recent years, however, a shortage in hardwood ties has developed due to increased demand by competing users of hardwoods and the cyclical nature in the level of railroad track maintenance. As a result, the American railroads have begun experimenting with crossties made of substitute materials, such as concrete (and to a lesser extent, steel), both of which are significantly more expensive than hardwood ties.

Although the use of concrete crossties has been quite successful in some foreign countries where such ties have been used extensively for a number of years, the recent experience of American railroads has shown that under some conditions concrete ties, as they are presently designed, have useful lives which are no longer, and possibly shorter, than the useful life of a typical wood tie. While it is possible these design problems will be solved, it is difficult to estimate when this might occur. As a result, Congress believes that the use of railroad ties made of pressed wood, concrete or other substitute materials should be accorded the same tax treatment as hardwood replacements receive under the retirement-replacement method of tax accounting.

Explanation of provision

Under the Act, an exception is provided to the general capitalization rules (sec. 263) to require replacement treatment where a domestic railroad, which uses the retirement-replacement method of accounting for depreciation of its railroad track, acquires and installs replacement ties which are not made of wood. As a result, current deductions will be allowed not only where an existing railroad tie is replaced by a tie of the same material and quality, as under prior law, but also where an existing tie is replaced with a tie of a different material or improved quality. This will apply, for example, where existing wood crossties are replaced with pressed wood, concrete or steel crossties. The current expense treatment applies to both material and labor costs involved in acquiring and installing replacement railroad ties. The current deduction for these replacement tie costs is, as under prior law, reduced by the salvage value of the old tie which is recovered in the replacement process.

Effective date

The provision is effective upon enactment.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

2. Limitation on Use of Investment Tax Credit for Railroad Property (sec. 1701(b) of the Act and sec. 46 of the Code)

Prior law

The amount of the investment tax credit which a taxpayer may take in any one year generally cannot exceed the first $25,000 of tax liability (as otherwise computed) plus 50 percent of the tax liability in excess of $25,000. However, in the case of public utility property, the Tax Reduction Act of 1975 increased the 50-percent limit to 100 percent for 1975 and 1976, 90 percent for 1977, 80 percent for 1978, 70 percent for 1979, and 60 percent for 1980.

Reason for change

Railroads have been investing heavily in equipment and facilities during the past several years in order to expand the ability of the railroad system to handle an increasing volume of traffic and to modernize the system through replacement of obsolete equipment and facilities. Additional expansion of the railroad system also is needed to connect new and reopened coal mines with principal railroad routes as reliance on coal as a fuel and energy source increases relative to other sources. Railroad equipment and facilities tend to be capital intensive and long-lived.

In contrast with the growth in investment requirements, earnings of railroad companies have been relatively small. Because the limitation on the amount of investment credit that may be claimed in a given year is expressed in terms of a percentage of tax liability, the railroads have not been able to use the credits as they have been earned, and substantial amounts of unused credits have accrued and been carried forward. For this reason, Congress decided to modify the limitation with respect to railroads for a temporary period.

Explanation of provision

The Act provides a temporary increase in the limitation on the amount of investment tax credit which may be used in a taxable year. Qualifying taxpayers will be allowed to apply investment tax credits against up to 100 percent of their tax liability in taxable years that end in 1977 and 1978 to the extent they invest in railroad property. This limitation is then to decrease by 10 percentage points in each of the subsequent five taxable years until the limitation returns to 50 percent in 1983.

In order to be eligible for this increase in the limitation, a minimum of 25 percent of the taxpayer's total qualified investment for the taxable year must have been in railroad property. Railroad property for this purpose is defined as section 38 property used by the taxpayer directly in connection with the trade or business carried on by the taxpayer of operating a railroad (including a railroad switching or terminal company). Thus, property which the taxpayer acquires and leases to an unrelated taxpayer for use in railroad operations is not considered as railroad property for this purpose.

The computation of the percentage limitation for railroad property is to be made on a taxpayer-by-taxpayer basis. Thus, a group of corporations which file a consolidated return together are to be treated as one taxpayer.

Congress intends that the benefit of the relaxation of the 50-percent limit go primarily to railroads. However, it recognizes that many railroads have varying amounts of nonrailroad property. In addition, many railroads are members of controlled groups that file consolidated returns. To achieve this objective in the most practical way administratively, Congress decided to prorate the increase in the credit limit in accordance with the extent to which the company (or the group filing the consolidated return) has qualified investment in railroad property, as compared to its qualified investment in other property.

Thus, if in 1977, 50 percent of the company's qualified investment is in railroad property, then the applicable limit is to be 75 percent of tax liability (the basic 50-percent limit plus one-half of the maximum additional limit allowable in 1977). If 70 percent of the company's qualified investment is in railroad property, then the applicable limit is to be 85 percent of the tax liability. In order to simplify such computations for most companies, if 75 percent or more of the qualified investment for a given year is in railroad property, then the full increase is to apply to that company for that year. Thus, the typical railroad, which has relatively little qualified investment in other property, is to get the full benefit of the increase in the percentage limitation.

If less than 25 percent of the qualified investment consists of railroad property, then no part of the additional limitation is to apply. In such a case, the company (or the group filing the consolidated return) is to be treated in its entirety as not being a railroad under this provision.

The percentage applicable to a taxpayer for a year is to apply to the aggregate of the credits arising from that taxpayer's railroad property and that taxpayer's other property; it is not to apply separately to each category of property.

If a taxpayer has credit that remains unusable despite the higher limits, any such excess is to be allowed as a carryback (3 years) and carryover (generally 7 years), as under present law. If there is a carryover or carryback to a year to which these higher limits apply, then the exact amount of the applicable limit is to be determined by the relative investments in the year to which the excess credit is carried. For example, assume that in 1977, 50 percent of company X's qualified investment is in railroad property. The maximum percentage limit in this case, as indicated above, is 75 percent of tax liability. Assume, further, that in 1978, 75 percent of company X's qualified investment consists of railroad property. The maximum credit for 1978 would then be (as indicated above) 100 percent of tax liability. If any of the excess credit from 1977 would be carried over to 1978 (after having been first carried back to 1974, 1975, and 1976, as under present law), the 1978 limit would not be affected by whether the amount carried over to that year could be traced originally to railroad property or to other property.

Effective date

The temporary increase in the limitation is effective with respect to taxable years ending after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $29 million in fiscal year 1977, $66 million in fiscal year 1978, and $41 million in fiscal year 1981.

3. Amortization of Railroad Grading and Tunnel Bores (sec. 1702 of the Act and sec. 185 of the Code)

Prior law

Domestic railroad common carriers may amortize railroad grading and tunnel bores placed in service after 1968 on a straight-line basis over a 50-year period. This amortization deduction is to be in lieu of any depreciation or any other amortization deduction for these grading and tunnel bores for any year for which the election applies. If the taxpayer elects to use this provision, it applies to all railroad grading and tunnel bores qualified for this amortization, unless the Secretary permits the taxpayer to revoke the election. The 50-year amortization period begins the year following the year the property is placed in service.

Railroad grading and tunnel bores, for which the 50-year amortization deduction is available, are all improvements that result from excavations (including tunneling), construction of embankments, clearings, diversions of roads and streams, sodding of slopes, and from similar work necessary to provide, construct, reconstruct, alter, protect, improve, replace or restore a roadbed or right-of-way for railroad track. Expenditures incurred for such improvements to an existing roadbed or railroad right-of-way are treated as costs incurred for property placed in service in the year in which the costs are incurred.

If a railroad grading or tunnel bore is retired or abandoned during a year for which this provision is in effect with respect to it, no deduction is to be allowed because of the retirement or abandonment. Instead, the amortization deduction under this provision is to continue to apply. An exception to this rule, however, is provided where the retirement or abandonment is attributable primarily to fire, storm, or other casualty. In such cases, the casualty loss deduction will be available in lieu of any further amortization deduction.

Reasons for change

Until the Tax Reform Act of 1969, no depreciation or amortization deduction could be taken by railroads for costs of railroad grading and tunnel bores. Although these expenses could be capitalized, railroads could not depreciate them over any period because the length of their useful life is uncertain and, it seemed, indefinitely long.

In enacting this provision in 1969, Congress decided that uncertainty about the expected useful life of railroad grading and tunnel bores could be resolved by selecting an arbitrary, long period as the useful life. Thus, railroads slowly could recoup the costs of these investments in relatively small annual charges.

Since approving the allowance for 50-year amortization was a significant departure from existing tax policy, Congress chose in 1969 to provide amortization for railroad grading and tunnel bores only on a prospective basis. As a result, the cost of properties placed in service before 1969 has not been depreciable for tax purposes, unless the taxpayer has been able to establish a useful life for tax purposes.

In the intervening period, Congress has studied the desirability of extending amortization to past investments in railroad property. The basic issue of allowing amortization of this otherwise nondepreciable property was resolved in the 1969 Act, and fair valuation of property placed in service in the past has been reached for the vast majority of grading and tunnel bores by the Interstate Commerce Commission and counterpart State regulatory bodies. As a result, Congress believes it is now appropriate to extend the 50-year amortization to railroad grading and tunnel bores placed in service before 1969.

In some instances in recent years, taxpayers have entered into litigation with the Federal Government to establish a depreciable base for railroad grading and tunnel bores under pre-1969 law. Congress does not intend that the election for 50-year amortization of pre-1969 properties will prejudice the rights of a taxpayer to seek an administrative or judicial determination of a depreciable base for such property.

Explanation of provision

The Act provides that taxpayers may elect 50-year amortization for railroad grading and tunnel bores placed in service before January 1, 1969 (pre-1969 railroad grading and tunnel bores). The amortizable basis of pre-1969 grading and tunnel bores that were acquired or constructed after February 28, 1913, is to be the adjusted basis of the property for determining capital gain in the hands of the taxpayer. For grading and tunnel bores in existence on February 28, 1913, the amortizable basis is to be that ascertained by the Interstate Commerce Commission as the property's new cost of reproduction, i.e., the then current cost of reproduction. If the valuation was made by a State regulatory agency that is the counterpart of the ICC, the adjusted basis of the property is to be the value of the property originally determined by the State agency. Where it has not been possible to establish a valuation for amortization under either of the procedures referred to, but the taxpayer or the Secretary can establish the adjusted basis for determining gain of the property in the hands of the taxpayer, the adjusted basis of the property in the hands of the taxpayer for determining gain is to be used.

The rules for determining the basis of railroad grading and tunnel bores are tied directly to existing procedures for that purpose. Since March 1, 1913, the Interstate Commerce Commission has been responsible for establishing the valuation of all railroad property, employing alternative valuation methods which include among them the cost of reproduction new. State governments generally have instructed their regulatory commissions to institute parallel evaluations for railroad property that would not be included within the ICC jurisdiction.

Grading and tunnel bores acquired or constructed since 1913 have readily established basis values because actual costs will have been established by the ICC or a State commission. Similarly, where disputes about valuations have not yet been resolved, Congress decided that for the purpose of this provision it would utilize a valuation that already had been determined for another Federal tax purpose, namely, the basis for determination of capital gain or loss.

Effective date

This provision is to be effective for any taxable year that begins after December 31, 1974.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of $26 million in fiscal year 1977 and $18 million a year thereafter.

4. Limitation on Use of Investment Tax Credit for Airline Property (sec. 1703 of the Act and sec. 46 of the Code)

Prior law

The amount of the investment tax credit that a taxpayer may take in any one year generally cannot exceed the first $25,000 of tax liability (as otherwise computed) plus 50 percent of the tax liability in excess of $25,000. However, in the case of public utility property, the Tax Reduction Act of 1975 increased the 50-percent limit tto 100 percent for 1975 and 1976, 90 percent for 1977, 80 percent for 1978, 70 percent for 1979, and 60 percent for 1980.

Reasons for change

For the past several years, many airlines have suffered losses or have experienced substantial reductions in earnings. As a consequence, investment credits earned in those years often could not be utilized and were carried forward. In some instances these credits from previous years may be lost to these taxpayers if the carryforward period for unused credits expires unless substantial income is earned in the carryforward years. This problem has been magnified because airline companies have tended to bunch their purchases of aircraft, especially when aircraft with substantially new design became available.

Presently, U.S. airline companies face the prospect of replacing many aging planes in their fleets. An important element in the companies' ability to finance new acquisitions is their cash flow, which depends in part upon the prospects for using in full the carryover of past investment credits as well as the investment credits that will be generated by the new acquisitions.

Explanation of provision

The Act provides a temporary increase in the limitation on the amount of investment tax credit which may be used in a taxable year. As a result, qualifying taxpayers will be allowed to apply investment tax credits against up to 100 percent of their tax liability in taxable years that end in 1977 and 1978 to the extent they invest in airline property. This limitation decreases by 10 percentage points in each of the subsequent five taxable years until the limitation returns to 50 percent in 1983.

In order to be eligible for this increase in the limitation, a minimum of 25 percent of the taxpayer's total qualified investment for the taxable year must have been in airline property. The Act provides that airline property under these provisions is defined as section 38 property used by the taxpayer directly in connection with the trade or business carried on by the taxpayer of the furnishing or sale of transportation as a common carrier by air subject to the jurisdiction of the Civil Aeronautics Board or the Federal Aviation Administration. Thus, for example, a taxpayer who acquires airline property which it leases to an unrelated person will not be eligible for the increased limitation with respect to that property.

The computation of the percentage limitation for airline property is to be made on a taxpayer-by-taxpayer basis. Thus, a group of corporations which file a consolidated return together are to be treated as one taxpayer.

Congress intends that the benefit of the relaxation of the 50-percent limit go primarily to airlines. However, it recognizes that airlines may have varying amounts of nonairline property. In addition, airlines may be members of controlled groups that file consolidated returns. To achieve this objective in the most practical way administratively, Congress decided to prorate the increase in the credit limit in accordance with the extent to which the company (or the group filing the consolidated return) has qualified investment in airline property, as compared to its qualified investment in other property.

Thus, if in 1977, 50 percent of the company's qualified investment is in airline property, then the applicable limit is to be 75 percent of tax liability (the basic 50-percent limit plus one-half of the maximum additional limit allowable in 1977). If 70 percent of the company's qualified investment is in airline property, then the applicable limit is to be 85 percent of the tax liability. In order to simplify such computations for most companies, if 75 percent or more of the qualified investment for a given year is in airline property, then the full increase is to apply to that company for that year. Thus, the typical airline, which has relatively little qualified investment in other property, is to get the full benefit of the increase in the percentage limitation.

If less than 25 percent of the qualified investment consists of airline property, then no part of the additional limitation is to apply. In such a case, the company (or the group filing the consolidated return) is to be treated in its entirety as not being an airline under this provision.

The percentage applicable to a taxpayer for a year is to apply to the aggregate of the credits arising from the taxpayer's airline property and other property—it is not to apply separately to each category of property.

If a taxpayer has credit that remains unusable despite the higher limits, any such excess is to be allowed as a carryback (3 years) and carryover (generally 7 years), as under present law. If there is a carryover or carryback to a year to which these higher limits apply, then the exact amount of the applicable limit is to be determined by the relative investments in the year to which the excess credit is carried. For example, assume that in 1977, 50 percent of company X's qualified investment is in airline property. The maximum percentage limit in this case, as indicated above, is 75 percent of tax liability. Assume, further, that in 1978, 75 percent of company X's qualified investment consists of airline property. The maximum credit for 1978 would then be (as indicated above) 100 percent of tax liability. If any of the excess credit from 1977 would be carried over to 1978 (after having been first carried back to 1974, 1975, and 1976, as under present law), the 1978 limit would not be affected by whether the amount carried over to that year could be traced originally to airline property or to other property.

Effective date

The temporary increase in the limitation to 100 percent is to be effective with respect to taxable years ending after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $32 million in fiscal year 1977, $55 million in fiscal year 1978, and $21 million in fiscal year 1981.

Q. INTERNATIONAL TRADE AMENDMENTS

1. United States International Trade Commission (sec. 1801 of the Act)

Prior law

Under prior law (section 330(d) of the Tariff Act of 1930), if a majority of the Commissioners on the International Trade Commission voting on an escape clause or market disruption case under section 201 or 406 of the Trade Act of 1974, respectively, could not agree on an injury determination or a remedy finding or recommendation, then the President could consider the "findings" agreed upon by one-half the number of Commissioners voting to be the "findings" of the Commission. If the Commission was equally divided into two groups, the President could consider the finding of either group to be the finding of the Commission. Also under prior law, a Commissioner was required to leave office on the day his term expired whether or not his successor was ready to take office.

Reasons for change

The amendment with respect to voting procedures was adopted to correct a defect in prior law which had prevented the operation of the Congressional override mechanism in cases where a plurality of three Commissioners reached agreement on a particular remedy but, because a majority of the Commissioners voting did not agree on a remedy, there was no "recommendation" by the Commission which Congress could implement under the override provisions in the Trade Act of 1974. The amendment with respect to Commissioner's terms was adopted to ensure that the Commission at all times has a full complement of Commissioners.

Explanation of provisions

Under the Act, if a majority of the Commissioners voting on an escape clause or market disruption case cannot agree on a remedy finding, then the remedy finding agreed upon by a plurality of not less than 3 Commissioners is to be treated as the remedy finding of the Commission for the purposes of the Congressional override in sections 202 and 203 of the Trade Act of 1974. If the Commission is tied on the remedy vote, and each voting group includes not less than 3 Commissioners, then (1) if the President takes the action recommended by one of those groups, the remedy finding agreed upon by the other group shall, for purposes of the Congressional override, be treated as the remedy finding of the Commission, or (2) if the President takes action which differs from the action agreed upon by both such groups, the remedy finding agreed upon by either such group may be considered by the Congress as the remedy finding of the Commission for purposes of the Congressional override. It is the intention of the conferees that this apply only for purposes of implementing the Congressional override in sections 202 and 203 of the Trade Act of 1974. It is not intended that this provision affect in any way the rules of procedure of the International Trade Commission.

Further, Congress strongly urges the Commissioners to reach majority agreement on all determinations, findings, and recommendations in all cases.

Also under the Act, a Commissioner may continue to serve as a Commissioner after the expiration of his term of office until his successor is appointed and qualified.

Effective date

These provisions are to apply to determinations, findings, and recommendations made after the date of enactment (after October 4, 1974).

Revenue effect

These provisions will have no effect on revenues.

2. Trade Act of 1974 Amendments (sec. 1802 of the Act)

Prior law

Under Title V of the Trade Act of 1974, eligible articles imported into the United States from beneficiary developing countries are duty free. Under section 502 of the Trade Act, certain countries are prohibited from being designated as beneficiary developing countries. The prohibitions apply to (1) Communist countries, generally; (2) members of OPEC; (3) countries which have expropriated U.S. property without prompt, adequate, and effective compensation; (4) countries which do not cooperate with the United States to prevent narcotics from unlawfully entering the United States; (5) countries which do not eliminate reverse preferences; and (6) countries which do not recognize arbitral awards to U.S. citizens. Prohibitions (4), (5) and (6) may be waived by the President if he determines that such a waiver will be in the national economic interest of the United States.

Reasons for change

The Congress believed that the problem of international terrorism has grown to proportions that parallel those problems relating to expropriations, drug trafficking, etc., for which prohibitions have been provided under Title V of the Trade Act of 1974.

Explanation of provision

Under the Act, a new prohibition is added to the definition of beneficiary developing country which provides that a country may not be so designated if it aids or abets, by granting sanctuary from prosecution to, any individual or group which has committed an act of international terrorism. This prohibition may be waived by the President if he determines that the waiver will be in the national economic interest of the United States.

Effective date

The provision is effective upon enactment (October 4, 1976).

Revenue effect

The provision will not have any effect on Federal revenues.

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R. "DEADWOOD" PROVISIONS

(Repeal and Revision of Obsolete, etc., Provisions of the Code)

The provisions provided in this title reflect a series of changes which have been developed over a number of years as an attempt to simplify the tax laws by removing from the Internal Revenue Code those provisions which are no longer used in computing current taxes or are little used and of minor importance. These changes have been popularly referred to as the "deadwood" provisions.

Title 19 repeals almost 150 sections of the Internal Revenue Code; it amends about 850 other sections. These provisions contain approximately 2,370 amendments to the Code (including the repealer provisions and changes where one section of the Code is amended several times).

This title deletes provisions in prior law which dealt only with past years, situations which were initially narrowly defined and are unlikely to recur, as well as provisions which have largely, if not entirely, outlived their usefulness. In addition, several amendments eliminate sex discrimination from the Code.

These provisions also make simplifying changes in Code language, such as the substitution of the term "ordinary income" for "gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)." The term "the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year" is replaced by "net capital gain." In another simplifying change, all references to "the Secretary or his delegate" are amended to refer only to "the Secretary" (which term includes his delegates), except where an act or regulation is required to be done or issued by the Secretary of the Treasury personally, in which case the Code will refer specifically to "the Secretary of the Treasury."

While these provisions are an attempt to simplify the Code by deleting "deadwood," they do not attempt to achieve simplification through substantive changes in the tax law.

SUBTITLE A—AMENDMENTS OF INTERNAL REVENUE CODE GENERALLY

SEC. 1901. AMENDMENTS OF SUBTITLE A; INCOME TAXES

Chapter 1. Normal Taxes and Surtaxes

Subchapter A. Determination of tax liability

Sec. 1901(a)(1) (amends sec. 2 of the Code)—definitions and special rules

This amendment makes it easier to read a provision relating to the tax status of certain married individuals living apart.

Sec. 1901(a)(2) (repeals sec. 35 of the Code)—partially tax-exempt interest received by individuals

This amendment repeals section 35 of the Code (relating to partially tax-exempt interest received by individuals) because there are no longer any outstanding Federal obligations producing interest which is partially tax-exempt under that section.

Section 242 of the Code, relating to such interest received by corporations, is repealed by section 1901(a)(33) of the Act. Appropriate conforming amendments striking out references to Code sections 35 and 242 and to partially tax-exempt interest in other Code sections are also made by the Act.

Sec. 1901(a)(3) (amends sec. 39 of the Code)—credit for taxes paid on gasoline, special fuels, and lubricating oil

These amendments strike out a transitional rule for the years 1965, 1966, and 1967 and conform the last sentence in Code section 39 to an amendment made by section 1906(a)(30)(B) of the Act.

Sec. 1901(a)(4) (amends sec. 46 of the Code)—investment credit

Subparagraph (A) corrects a clerical error in the Employee Retirement Income Security Act of 1974 ("ERISA"). Subparagraph (B) changes a citation to conform with current practice.

Sec. 1901(a)(5) (amends sec. 48 of the Code)—definitions and special rules

These amendments change citations to conform with current practices.

Sec. 1901(a)(6) (amends sec. 50A of the Code)—work incentive credit

This amendment corrects a clerical error in ERISA.

Sec. 1901(a)(7) (repeals sec. 51 of the Code)—tax surcharge

This amendment repeals tax surcharge provisions applicable to 1968, 1969, and 1970.

Subchapter B. Computation of taxable income

Sec. 1901(a)(8) (amends sec. 62 of the Code)—Penalties for early withdrawal of funds from certain savings accounts

Section 62 contains two paragraphs numbered (11). In 1974, Public Law 93–483 added to section 62 a new paragraph (11) (allowing a deduction from gross income for interest "penalties" incurred upon early withdrawals from time savings accounts or deposits). A few months earlier, ERISA had also added a new paragraph (11) (pertaining to lump sum distributions from certain pension plans). Subparagraph (A) of the present bill redesignates the paragraph added by Public Law 93–483 as paragraph (12).

Sec. 1901(a)(9) (additional amendment of sec. 62 of the Code)—penalties for early withdrawal of funds from certain savings accounts

This paragraph corrects a clerical error in the paragraph of the Code which is redesignated as paragraph (12) of section 62 by section 1901(a)(8) of the Act.

Sec. 1901(a)(10) (adds sec. 64 to the Code)—definition of ordinary income

This paragraph adds a new section to the Code to replace the cumbersome and lengthy terminology of present law which describes certain gains from sales or exchanges of property which do not qualify as capital gains. Many provisions of present law describe these gains as: "gain from the sale or exchange of property which is not a capital asset or property described in section 1231(b)."

For this language, the Act substitutes a shorter term: "ordinary income."

"Ordinary income" is defined as including "any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). Any gain from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as 'ordinary income' shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)."

Sec. 1901(a)(11) (adds sec. 65 to the Code)—definition of ordinary loss

This paragraph is the counterpart to section 1901(a)(10), which defines "ordinary income." This paragraph provides a brief definition of "ordinary loss" to replace "loss from the sale or exchange of property which is not a capital asset." The new definition provides that "ordinary loss" includes "any loss from the sale or exchange of property which is not a capital asset." In the case of property which is a capital asset, the new term also includes loss from the sale or exchange of property which is treated or considered, under other provisions of the Code, as "ordinary loss."

Sec. 1901(a)(12) (amends sec. 72 of the Code)—annuities; certain proceeds of endowment and life insurance contracts

Subparagraph (A) strikes out an internal effective date (January 1, 1954) and a reference to prior laws no longer needed.

Sec. 1901(a)(13) (additional amendment of sec. 72 of the Code)—annuities; certain proceeds of endowment and life insurance contracts

This paragraph corrects a clerical error made in ERISA.

Sec. 1901(a)(14) (amends sec. 76 of the Code)—mortgages made or obligations issued by joint-stock land banks

This amendment repeals an obsolete provision relating to the taxation of income (except interest) from joint-stock land bank mortgages or obligations. Joint-stock land banks have not been permitted to make new loans after May 12, 1933, and it is understood that there are no joint-stock land bank mortgages or obligations currently outstanding.

Sec. 1901(a)(15) (amends sec. 83 of the Code)—property transferred in connection with performance of services

This amendment strikes out an internal effective date ("30 days after the date of the enactment of the Tax Reform Act of 1969") relating to a date by which a certain election could be made.

Sec. 1901(a)(16) (amends sec. 101 of the Code)—certain death benefits

This amendment strikes out an internal effective date.

Sec. 1901(a)(17) (amends sec. 103 of the Code)—interest on certain governmental obligations

These amendments strike out provisions relating to the tax-exempt status of the interest on United States obligations, since there are no outstanding obligations of the United States or of any United States instrumentality which pay interest that is exempt from tax under this section. Also, the list of cross references in section 103(e) of the Code is updated.

Sec. 1901(a)(18) (amends sec. 104 of the Code)—compensation for injuries or sickness

This amendment makes conforming changes in citations to other titles of the United States Code.

Sec. 1901(a)(19) (amends sec. 115 of the Code)—income of States, municipalities, etc.

This amendment repeals subsections (b) and (c) relating to certain contracts entered into before September 8, 1916, and May 29, 1928 (relating to certain public utilities and certain bridge acquisitions, respectively), since it appears that no such contracts are still in effect.

Sec. 1901(a)(20) (amends sec. 116 of the Code)—partial exclusion of dividends received by individuals

This amendment strikes out an internal effective date.

Sec. 1901(a)(21) (amends sec. 124 of the Code)—cross references to other Acts

This amendment updates a list of cross references to other Acts.

Sec. 1901(a)(22) (amends sec. 143 of the Code)—determination of marital status

This amendment makes section 143 (relating to determination of marital status) applicable for purposes of part V (deductions for personal exemptions) of subchapter B, as well as for purposes of part IV (standard deduction) of that subchapter. As a result of this amendment, section 153 becomes redundant and is repealed by section 1901(b)(7)(A)(i) of this title.

Sec. 1901(a)(23) (amends sec. 151 of the Code)—allowance of deductions for personal exemptions

This amendment replaces the definition of "educational institution" with a cross reference to a similar definition in section 170(b)(1)(A)(ii). This consolidates in one section the definition of an "educational organization." The amendment makes conforming amendments to 11 other Code sections to reflect this change. (Note that an educational organization described in clause (ii) of section 170(b)(1)(A) may be a private, for-profit school. However, even though such a school could satisfy the requirements of the dependency provisions, relating to full-time students, it could not be an eligible donee of deductible charitable contributions, because it could not satisfy the requirements of any of the paragraphs of subsection (c) of section 170).

Sec. 1901(a)(24) (amends sec. 152 of the Code)—definition of dependent

Subparagraph (A) deletes the "sick cousin rule," which includes as dependents certain distant relatives receiving institutional care who previously had resided with the taxpayer. This provision was added to the Code to cover an unusual situation unlikely to recur.

Subparagraph (B) eliminates another provision allowing dependency deductions under two rarely used rules. Under one of these rules, a child residing in the Philippine Islands qualifies as a dependent if he was born to, or adopted by, the taxpayer in the Philippines before January 1, 1956, if the taxpayer was then a member of the U.S. Armed Forces. Under the other rule, a resident of the Canal Zone or Panama may be claimed as a dependent although he is not a citizen or national of the United States.

Sec. 1901(a)(25) (amends sec. 164 of the Code)—deduction for taxes

These amendments strike out an effective date provision (sales after December 31, 1953) and an obsolete transitional rule, both of which relate to the apportionment of taxes on real property between seller and purchaser.

Sec. 1091(a)(26) (amends sec. 165 of the Code)—losses

These amendments strike out the provision that treats Cuban expropriation losses of individuals on personal-use assets as casualty losses, since this provision applies only to losses sustained before January 1, 1964.

Sec. 1901(a)(27) (amends sec. 167 of the Code)—depreciation

Subparagraph (A) substitutes "August 16, 1954," for "the date of enactment of this title" as the effective date of a provision.

Subparagraph (B) substitutes "October 16, 1962" for "the date of enactment of the Revenue Act of 1962" as the effective date of a provision.

Subparagraph (C) substitutes the exact date ("before June 29, 1970,") for "within 180 days after the date of enactment of this subparagraph," as the date by which an election must have been made under a provision.

Sec. 1901(a)(28) (amends sec. 170 of the Code)—charitable, etc., contributions and gifts

Subparagraph (A) strikes out the unlimited deduction for charitable contributions, which, by its own terms, expires for taxable years beginning after December 31, 1974.

Subparagraph (B) deletes a special percentage rate by which excess charitable contributions from a contribution year beginning before January 1, 1970, could be carried over to subsequent taxable years.

Subparagraphs (C) and (D) eliminate an unnecessary citation and bring up to date statutory citations in the cross references at the end of section 170.

Sec. 1901(a)(29) (amends sec. 172 of the Code)—net operating loss deduction

Subparagraph (A) deletes the special five year loss carryback permitted to American Motors Corporation in 1967 (sec. 172(b)(1)(E)), which has now expired by its own terms.

Subparagraph (B) strikes out an obsolete effective date provision (taxable years ending after December 31, 1953) relating to the definition of net operating loss.

Subparagraphs (C) and (E) delete obsolete transitional rules for 1953 and 1954, for 1957 and 1958, and for 1955 and 1956. Subparagraph (D) deletes a reference to the date of January 1, 1954, which is no longer necessary.

Sec. 1901(a)(30) (amends secs. 174 and 175 of the Code)—research and experimental expenditures and soil and water conservation expenditures

These amendments delete "the date on which this title is enacted" and substitute the exact date, August 16, 1954.

Sec. 1901(a)(31) (repeals sec. 187 of the Code)—rapid amortization for certain coal mine safety equipment

Section 187 of the Code is repealed because it is applicable, by definition, only to coal mine safety equipment placed in service before January 1, 1976. The special 60-month rapid amortization for qualifying property placed in service before January 1, 1976, is not to be affected by this repeal.

Sec. 1901(a)(32) (amends sec. 219 of the Code)—disqualification of governmental plan participants from distributing to individual retirement accounts

This provision corrects a clerical error in ERISA.

Sec. 1901(a)(33) (repeals sec. 242 of the Code)—partially tax-exempt interest received by corporations

Section 242 of the Code is repealed because there are no longer any outstanding Federal obligations that pay interest that is partially exempt from income tax under that section. (See the corresponding repeal of sec. 35 of the Code, by sec. 1901(a)(2) of this title.)

Sec. 1901(a)(34) (amends sec. 243 of the Code)—dividends received by corporations

Subparagraph (A) adds a citation to the Investment Act of 1958.

Subparagraph (B) strikes out a parenthetical clause which applies only in certain cases in which the taxable year of a member corporation in an affiliated group began in 1963 and ended in 1964.

Sec. 1901(a)(35) (amends sec. 247 of the Code)—dividends paid on certain preferred stock of public utilities

This provision revises section 247(b)(2) of the Code (defining preferred stock) to make it easier to read. The substance of the definition is unchanged.

Sec. 1901(a)(36) (amends sec. 248 of the Code)—organizational expenditures

This amendment substitutes "August 16, 1954" for "the date of enactment of this title" as the effective date of this provision.

Sec. 1901(a)(37) (amends sec. 265 of the Code)—expenses and interest relating to tax-exempt income

This amendment strikes out an obsolete reference to tax-exempt interest from obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer. No such obligations paying tax-exempt interest are outstanding.

Sec. 1901(a)(38) (amends sec. 269 of the Code)—acquisitions made to evade or avoid income tax

This amendment repeals the presumption of a tax avoidance purpose in certain cases where the consideration paid for stock or assets of a corporation is disproportionate to the total of the adjusted basis of the assets of the acquired corporation plus the amount of tax benefits obtained through the acquisition (sec. 269(c)).

This presumption seems to be contrary to the purpose of the provision; i.e., usually tax avoidance motives would be more apt to be present where the value of "tax benefits" was paid for, than they would be where the "tax benefits" were not given weight. Moreover, under general tax litigation principles, the Commissioner's determination of a tax avoidance motive is presumptively correct and the burden of production of evidence is already on the taxpayer.

Sec. 1901(a)(39) (amends sec. 275 of the Code)—nondeductible taxes

This amendment deletes the obsolete reference to corresponding provisions of prior, i.e., pre-1954 Code, laws in the provision denying a deduction for income tax withheld from wages.

Sec. 1901(a)(40) (amends sec. 281 of the Code)—terminal railroad corporations

Subparagraph (A) inserts a citation to the Interstate Commerce Act.

Subparagraph (B) strikes a transitional provision applicable to taxable years ending before October 23, 1962.

Subchapter C. Corporate distributions and adjustments

Sec. 1901(a)(41) (amends sec. 301 of the Code)—corporate distributions

This provision repeals section 301(e) of the Code, which relates to distributions out of certain earnings and profits by corporations which were classified as personal service corporations under the Revenue Acts of 1918 or 1921. It is not believed that there are any such corporations that have not already distributed the earnings and profits to which this section applies.

Sec. 1901(a)(42) (amends sec. 311 of the Code)—taxability of corporation on distribution

Subparagraph (A) corrects a clerical error in subsection (d)(1) which occurred in 1969 when the two words "a gain" were erroneously printed as "again".

Subparagraph (B) strikes out one of the exceptions to the general rule of subsection (d)(1) requiring recognition of gain at the corporate level on a redemption distribution of appreciated property. The deleted exception relates to certain distributions required to be made before December 1, 1974.

Subparagraph (C) strikes out two unnecessary statutes-at-large citations.

Sec. 1901(a)(43) (amends sec. 312 of the Code)—effect of distributions on earnings and profits

Subparagraph (A) makes two clerical corrections in replacing references to "this Code" with references to "this title."

Subparagraph (B) deletes a subsection providing rules for computing earnings and profits with respect to distributions by personal service corporations under the 1939 code. Since earnings and profits adjustments for a taxable year are based on the law applicable to that year, this amendment does not affect the current taxable year and future years.

Subparagraphs (C) and (D) strike out effective dates that do not apply to current taxable years.

Sec. 1901(a)(44) (amends sec. 333 of the Code)—election as to recognition of gain in certain liquidations

This amendment strikes out an obsolete effective date provision (June 22, 1954) relating to adoption of a plan of liquidation of a corporation.

Sec. 1901(a)(45) (amends sec. 334 of the Code)—basis of property received in liquidations

These amendments delete obsolete effective date provisions (June 22, 1954) relating to adoption of a plan of corporate liquidation.

Sec. 1901(a)(46) (amends sec. 337 of the Code)—gain or loss on sales or exchanges in connection with certain liquidations

These amendments delete obsolete effective date provisions (June 22, 1954, and January 1, 1958) relating to adoption of a plan of corporate liquidation.

Sec. 1901(a)(47) (repeals sec. 342 of the Code)—liquidation of certain foreign personal holding companies

This amendment repeals the provision taxing, as short-term capital gain, gain on the liquidation of certain corporations that were foreign personal holding companies in 1937. The corporations affected by this provision were given a chance to liquidate at long-term capital gain rates for a period after this provision was enacted, and again in 1954 through 1956. Moreover, the rule does not apply to sales of stock, and long-term capital gain rates could be obtained by selling the stock rather than liquidating the corporation. It seems likely that the provision will rarely, if ever, be applied, and therefore is deleted as unimportant and rarely used.

Sec. 1901(a)(48) (amends sec. 351 of the Code)—transfer to controlled corporations

These amendments strike out an obsolete effective date (June 30, 1967) and a transitional rule. They also make explicit the rule of present law that a transfer to an investment company (a so-called "swap fund") is not accorded tax-free exchange treatment under section 351.

Sec. 1901(a)(49) (repeals sec. 363 of the Code)—effect on earnings and profits

This provision repeals an unnecessary cross reference provision relating to the effect on earnings and profits of corporate organizations and reorganizations.

Sec. 1901(a)(50) (amends sec. 371 of the Code)—reorganization in certain receivership and bankruptcy proceedings

These amendments strike out unnecessary citation references and insert a citation to the U.S. Code.

Sec. 1901(a)(51) (amends sec. 372 of the Code)—basis in connection with certain receivership and bankruptcy proceedings

This amendment strikes out an unnecessary citation reference to the Statutes at Large.

Sec. 1901(a)(52) (repeals sec. 373 of the Code)—loss not recognized in certain railroad reorganizations

This provision repeals the provisions for nonrecognition of loss on transfers made before August 1, 1955, in certain railroad reorganizations, pursuant to a court order. The related basis provisions are moved to section 374(b) of the Code by section 1901(b)(14)(B) of the title.

Sec. 1901(a)(53) (amends sec. 374 of the Code)—gain or loss not recognized in certain railroad reorganizations

This amendment revises a citation to the Bankruptcy Act to conform to current practice.

Sec. 1901(a)(54) (amends sec. 381 of the Code)—carryovers in certain corporate acquisitions

This amendment deletes an obsolete provision dealing with the deduction by the acquiring corporation of contributions to a pension plan made by its wholly-owned subsidiary whose assets were acquired in a liquidation subject to the 1939 Code.

Sec. 1901(a)(55) (repeals secs. 391 through 395 of the Code)—effective date of subchapter C

This section strikes out the effective date provisions of subchapter C of chapter 1 of subtitle A. These provisions are not needed for transactions occurring after the effective date of the repeal (i.e., taxable years beginning after December 31, 1975).

Subchapter D. Deferred compensation, etc.

Sec. 1901(a)(56) (amends sec. 401 of the Code)—relating to requirements for qualification of certain retirement plans

Subparagraphs (A), (B), and (C) replace references to "the date of enactment of the Employee Retirement Income Security Act of 1974" or to "enactment of the Employee Retirement Income Security Act of 1974" with that date of enactment (September 2, 1974). Subparagraph (D) corrects an error in margination.

Sec. 1901(a)(57) (amends sec. 402 of the Code)—taxability of beneficiary of employees' trust

Subparagraph (A) replaces an obsolete citation and it replaces four references to "basic salary" by references to "basic pay", in conforming Code provisions relating to Civil Service retirement laws to changes in those laws made by Public Law 89–554 in 1966.

Subparagraph (B) deletes from the Code subsection (d) of section 402, an absolete provision pertaining to certain trust agreements made before October 21, 1942.

Subparagraph (C) amends section 402(e)(4)(A) to make clear the intent of Congress in enacting the Employee Retirement Income Security Act of 1974 that the distribution of an annuity contract is not in and of itself to be treated as a taxable lump sum distribution, although the value of the contract can affect the amount of tax imposed on account of distributions of other property. This amendment is made retroactive to the effective date of the lump sum distribution taxation provisions of the 1974 Act.

Sec. 1901(a)(58) (amends sec. 403 of the Code)—rollover of employee annuities

This provision corrects an error in margination made in ERISA.

Sec. 1901(a)(59) (amends sec. 404 of the Code)—certain deductions for contributions to a pension plan.

This provision repeals section 404(d), which permits limited carryovers of certain pension plan contribution deductions from 1939 Code years to 1954 Code years if the carryover deductions would have been allowable if the 1939 Code provisions had remained in effect. It is believed that any such eligible carryovers have by now been used or lost.

Sec. 1901(a)(60) (amends sec. 409 of the Code)—rollover contributions from individual retirement accounts or individual retirement annuities

This provision corrects a typographical error in ERISA.

Sec. 1901(a)(61) (amends sec. 410 of the Code)—minimum participation standards

Subparagraph (A) is a clerical amendment to conform to current drafting style. Subparagraph (B) substitutes "September 2, 1974," for "the date of enactment of the Employee Retirement Income Security Act of 1974". Subparagraph (C) substitutes "September 1, 1974" for "the day before the date of the enactment of this section".

Sec. 1901(a)(62) (amends sec. 411 of the Code)—minimum vesting standards

Subparagraph (A) makes a change in wording to conform to current drafting style. Subparagraph (B) in three places substitutes September 2, 1974, for references to the date of enactment of ERISA. Subparagraph (C) corrects a typographical error in a heading. Subparagraph (D) also twice substitutes September 2, 1974, for references to the date of enactment of ERISA. Subparagraph (E) substitutes "September 1, 1974" for a reference to the day before the date of enactment of ERISA.

Sec. 1901(a)(63) (amends sec. 412 of the Code)—minimum funding standards

Subparagraph (A) substitutes "September 1, 1974" for a reference to the day before the date of enactment of ERISA. Subparagraph (B) substitutes "September 2, 1974" for a reference to the date of enactment of ERISA.

Sec. 1901(a)(64) (amends sec. 414 of the Code)—definitions and special rules

Subparagraph (A) corrects a typographical error in ERISA. Subparagraph (B) substitutes "September 2, 1974" for a reference to the date of enactment of ERISA.

Sec. 1901(a)(65) (amends sec. 415 of the Code)—limitations on benefits and contributions under qualified plans

These amendments correct clerical errors in ERISA.

Subchapter E. Accounting periods and methods of accounting

Sec. 1901(a)(66) (amends sec. 453 of the Code)—installment method

Subparagraph (A) is a clerical amendment substituting a reference to the 1954 Code for an erroneous reference to the 1939 Code.

Subparagraph (B) corrects a grammatical error by striking the words "or section" which improperly appear in a list of Code sections.

Sec. 1901(a)(67) (amends sec. 455 of the Code)—prepaid subscription income

This amendment strikes out an obsolete effective date provision (taxable years beginning after December 31, 1957) relating to an election to have section 455 of the Code apply to certain prepaid subscription income of the taxpayer.

Sec. 1901(a)(68) (amends sec. 456 of the Code)—prepaid dues income of certain membership organizations

This amendment deletes an obsolete effective date provision (taxable years beginning after December 31, 1960) relating to an election to have section 456 of the Code apply to certain prepaid dues income of the taxpayer.

Sec. 1901(a)(69) (amends sec. 461 of the Code)—general rule for taxable year of deduction

Subparagraph (A) deletes the obsolete transitional rule relating to deduction by an accrual basis taxpayer of real property taxes deductible under the Internal Revenue Code of 1939 or deductible for the taxpayer's first taxable year which began after December 31, 1953.

Subparagraph (B) deletes an obsolete effective date provision (taxable years beginning after December 31, 1953) relating to an election with respect to the deduction of real property taxes by a taxpayer using an accrual method of accounting.

Sec. 1901(a)(70) (amends sec. 481 of the Code)—adjustments required by changes in method of accounting

These amendments delete special provisions which provide that certain adjustments attributable to pre-1954 Code years resulting from a change in method of accounting be taken into account over a 10-year period beginning with the year of change. These provisions do not apply with respect to changes in methods of accounting made in taxable years beginning after December 31, 1963, and are therefore obsolete.

Sec. 1901(a)(71) (amends sec. 508 of the Code)—special rules for certain exempt organizations

Subparagraph (A) strikes provisions stating that the time for new organizations to give the required notice to the Secretary regarding section 501(c)(3) status and private foundation status shall not expire before the 90th day after the day on which regulations first prescribed under section 508 (a) and (b) become final. Those regulations became final on December 21, 1972.

Subparagraph (B) deletes a special rule for private foundations organized before January 1, 1970. This rule applies to taxable years beginning before January 1, 1972. Subparagraph (C) is a conforming amendment to the changes made by subparagraph (B).

Sec. 1901(a)(72) (amends sec. 514 of the Code)—unrelated debt-financed income

Subparagraph (A) strikes out a transitional rule that applied to taxable years beginning before January 1, 1972.

Subparagraph (B) strikes out the lengthy definitions of "business lease" and "business lease indebtedness". These definitions are needed only in connection with a rule of limited application set forth in section 514(b)(3)(C)(iii) and in the rule deleted by subparagraph (A). These definitions are replaced in subparagraph (C) with an appropriate reference to prior law.

Subparagraph (D) strikes the term "premises" from a definitional section because that term is no longer used in section 514.

Subchapter G. Corporations used to avoid income tax on shareholders

Sec. 1901(a)(73) (amends sec. 534 of the Code)—burden of proof with respect to the accumulated earnings tax

These amendments delete the obsolete transitional rules providing for the retroactive application of the 1954 Code burden of proof requirement with respect to the accumulated earnings tax to proceedings involving 1939 Code years.

Sec. 1901(a)(74) (amends sec. 535 of the Code)—accumulated taxable income

This amendment strikes out a reference to 1939 Code excess profits taxes that have been repealed.

Sec. 1901(a)(75) (amends sec. 537 of the Code)—reasonable needs of the business

These amendments strike out an internal effective date provision (May 26, 1969) relating to the definition of excess business holdings redemption needs.

Sec. 1901(a)(76) (amends sec. 542 of the Code)—definition of personal holding company

Subparagraph (A) strikes out a provision that prevents certain exempt organizations from being treated as individuals for purposes of the personal holding company definition. The provision applies only if the organization owned all of the corporation's common stock and 80 percent of its other stock at all times on or after July 1, 1950. It is likely that these corporations have been liquidated since 1955, when this provision was enacted, because income from investments would be taxable if held in such a corporation, but would be tax-free if held by the exempt organization directly.

Subparagraph (B) amends a provision limiting the ability of a consolidated group to compute its personal holding company tax on a consolidated basis. The amendment strikes out an exception for groups of railroad corporations that would be eligible to file a consolidated return under the provisions of the 1939 Code before its amendment in 1942. It appears that this exception is no longer needed, since it would apply only to a group of railroad corporations that files consolidated returns and meets the five-or-fewer-shareholders test.

Subparagraph (C) amends a cross reference to conform to the amendment of section 7701(a)(19) by the Tax Reform Act of 1969.

Subparagraph (D) adds a U.S. Code citation to conform to current practice.

Sec. 1901(a)(77) (amends sec. 545 of the Code)—undistributed personal holding company income

Subparagraph (A) strikes out a reference to repealed 1939 excess profits taxes. It also eliminates a provision permitting a personal holding company that deducted taxes on the cash basis during 1939 Code years to continue to do so until it makes an irrevocable election to use the accrual basis. It seems unlikely that a significant number of companies have not elected to accelerate their deductions by using the accrual basis.

Subparagraph (B) strikes out a provision allowing the deduction of amounts used or set aside to retire indebtedness incurred before 1934. It seems likely that virtually all of this indebtedness has now been retired.

Subparagraph (C) strikes out "the date of enactment of this subsection" in section 545(c)(2)(A) and substitutes the exact date (February 26, 1976).

Sec. 1901(a)(78) (amends sec. 547 of the Code)—deduction for deficiency dividends

This amendment deletes a 1954 Code effective date provision that is no longer needed.

Sec. 1901(a)(79) (amends sec. 551 of the Code)—foreign personal holding companies

This clerical amendment inserts a word ("income") erroneously omitted from this section.

Sec. 1901(a)(80) (amends sec. 556 of the Code)—undistributed foreign personal holding company income

This amendment deletes a reference to 1939 Code excess profits taxes that have been repealed.

Sec. 1901(a)(81) (amends sec. 564 of the Code)—dividend carryover

This amendment strikes out a transitional provision relating to dividend carryovers from pre-1954 Code years for purposes of computing the dividends-paid deduction of a personal holding company.

Subchapter H. Banking institutions

Sec. 1901(a)(82) (repeals sec. 583 of the Code)—deductions of dividends paid on certain preferred stock

This amendment strikes out provisions relating to deductions of dividends paid on certain preferred stock by banks or trust companies. It appears that none of this stock is now outstanding and that these provisions are no longer needed.

Sec. 1901(a)(83) (repeals sec. 592 of the Code)—deduction for repayment of certain loans

This paragraph repeals the provision allowing certain mutual savings banks to deduct certain repayments of pre-September 1, 1951, loans. All the loans described in the section have been repaid and therefore the provision is no longer applicable.

Sec. 1901(a)(84) (amends sec. 593 of the Code)—reserves for losses on loans

Subparagraph (A) strikes out the applicable percentages to be used by mutual savings banks in computing the addition to reserves for bad debts under the percentage of taxable income method for years 1969 through 1975.

Subparagraph (B) deletes the obsolete portions of paragraphs (2) through (5) of section 593(c) which deal with the required allocation of the bad debts reserves of mutual savings banks on December 31, 1962.

Subparagraphs (C) and (D) strike out a transitional rule for a taxable year beginning in 1962 and ending in 1963 that deals with the treatment of bad debts reserves of mutual savings banks and make an internal conforming change.

Sec. 1901(a)(85) (repeals sec. 601 of the Code)—special deduction for bank affiliates

This paragraph repeals a special deduction allowed bank affiliates in computing the accumulated earnings tax and the personal holding company tax. The deduction is for the amount of earnings and profits required to be invested in a reserve of readily marketable assets under the Banking Act of 1933. This requirement was eliminated in 1966, and there is now no requirement that such a reserve be maintained.

Subchapter I. Natural resources

Sec. 1901(a)(86) (amends sec. 613A of the Code)—depletion for oil and natural gas from secondary or tertiary processes

Subparagraph (A) eliminates a reference to a subparagraph of the Code that was deleted by Public Law 94–12, the Tax Reduction Act of 1975 (sec. 613(b)(1)(A) of the Code). The present section 613(b)(1)(A) was, prior to that act, section 613(b)(1)(B).

Sec. 1901(a)(87) (amends sec. 614 of the Code)—definition of property

These amendments strike out complex and seldom used provisions relating to recapture of taxes saved by delaying an election to aggregate mineral properties from the date of first exploration to the date of development of the mine.

Sec. 1901(a)(88) (repeals sec. 615 of the Code)—pre-1970 exploration expenditures

This amendment repeals section 615 of the Code, which provided a deduction for certain mineral exploration expenditures paid or incurred before January 1, 1970. Although a taxpayer could elect under section 615(b) to defer the deduction of such pre-1970 expenditures until the units of produced ores or minerals discovered by reason of such expenditures were sold, it is believed that no such elections are in effect.

Conforming amendments include the addition of a new subsection (i) to section 617 of the Code. This new subsection (i) preserves the rules (formerly set forth in section 615(g)(2)) which provide that amounts deducted under section 615 with respect to mineral property by the transferor of such property will be subject to recapture by the transferee in certain circumstances under section 617.

Sec. 1901(a)(89) (amends sec. 617 of the Code)—deduction and recapture of certain mining exploration expenditures

This amendment strikes out a provision allowing the revocation without consent of an election if the revocation was made within 3 months after the month in which final regulations were published under section 617(a) of the Code. Such regulations were published on June 30, 1972, so this provision is no longer needed.

Sec. 1901(a)(90) (repeals sec. 632 of the Code)—maximum tax on sales of certain oil or gas properties

This amendment strikes out a provision (sec. 632) which limits to 32 percent the tax on sales of oil or gas properties the principal value of which has been demonstrated by prospecting or discovery done by the taxpayer himself. To qualify, the taxpayer must be an individual, not a corporation.

This provision was enacted in 1918 to encourage oil and gas development and to lower the tax rate on such a sale in view of the years that might be consumed in discovery work prior to such a sale. This provision was deleted in 1934, but reinstated in 1936 to encourage individuals in competition with corporations and because Congress believed that the 1934 deletion had discouraged sales of such properties.

Before 1969 this section was probably seldom used because the 25-percent alternative capital gain rate was lower than the maximum tax rate under section 632. In the Tax Reform Act of 1969, Congress increased the maximum capital gain tax rate for individuals to 35 percent. Congress did not then intend to create a preference rate which is less than the general maximum capital gain rate.

Subchapter J. Estates, trusts, beneficiaries, and dependents

Sec. 1901(a)(91) (amends sec. 691 of the Code)—income in respect of decedents

This amendment strikes out a reference to an obsolete effective date provision (sec. 683 of the Code). That effective date provision is eliminated by the amendment of section 683 by section 2131(e) of the Act.

Sec. 1901(a)(92) (amends sec. 692 of the Code)—members of the Armed Forces dying during an induction period

This is a clerical amendment changing "on" to "of" in the heading of the section.

Subchapter K. Partners and partnerships

Sec. 1901(a)(93) (amends sec. 751 of the Code)—properties to be treated as unrealized receivables.

This amendment eliminates a clerical error which retained an unnecessary word ("or") in a listing of Code sections.

Sec. 1901(a)(94) (repeals sec. 771 of the Code)—effective date provision of subchapter K

This provision deletes the obsolete effective date provisions (generally, December 31, 1954) for subchapter K of chapter 1 (relating to partners and partnerships). The repeal of Code section 771(b)(1) (relating to adoption of taxable year) does not require any existing partner or partnership to change to a different taxable year or change his (or its) manner of reporting income. Thus, for example, if an existing partnership adopted a fiscal year beginning before April 2, 1954, and an individual who subsequently becomes a principal partner in that partnership adopts a taxable year that is different from that of the partnership, the repeal of section 771(b)(1) by the bill does not require either the principal partner or that partnership to change to the taxable year of the other.

Subchapter L. Insurance companies

Sec. 1901(a)(95) (amends sec. 802 of the Code)—tax on life insurance companies

Subparagraph (A) deletes an obsolete effective date provision (taxable years beginning after December 31, 1957) relating to the imposition of tax on a life insurance company.

Subparagraph (B) deletes an obsolete effective date provision (taxable years beginning after December 31, 1961) relating to the alternative tax in the case of capital gains of a life insurance company.

Subparagraph (C) deletes an obsolete special rule for computing the tax for a taxable year of a life insurance company beginning in 1959 or 1960.

Sec. 1901(a)(96) (amends sec. 804 of the Code)—taxable investment income

Subparagraph (A) strikes out a special rule which, in effect, provides for any adjustment necessary to prevent a life insurance company from being taxed on tax-exempt interest or dividends qualifying for a dividend received deduction. This special rule is surplusage because the basic life insurance company tax provisions have been held to prevent the imposition of tax on these items.

Subparagraph (B) strikes out an internal effective date provision (taxable years beginning after December 31, 1958) relating to the computation of life insurance company gross investment income.

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Sec. 1901(a)(97) (amends sec. 805 of the Code)—policy and other contract liability requirements

Subparagraph (A) strikes out an obsolete provision pertaining to the earnings rate of life insurance companies for taxable years beginning before January 1, 1958.

Subparagraph (B) strikes out a parenthetical clause which provides that the adjusted basis of certain assets which a life insurance company must take into account in computing its taxable income is determined without regard to the fair market value of the assets on December 31, 1958. This clause was surplusage when enacted and continues to be surplusage since the adjusted basis of these assets is not affected by their fair market value on December 31, 1958.

Subparagraph (C) strikes out traditional rules, relating to the amount taken into account as pension plan reserves, for taxable years beginning after December 31, 1957, and before January 1, 1961.

Sec. 1901(a)(98) (amends sec. 809 of the Code)—gain and loss from operations

Subparagraph (A) strikes out a special rule which, in effect, provides for any adjustments necessary to prevent a life insurance company from being taxed on tax-exempt interest or dividends qualifying for a dividends received deduction. This special rule is surplusage because the basic life insurance company tax provisions have been held to prevent the imposition of tax on these items.

Subparagraphs (B) and (C) strike out obsolete provisions relating to certain deductions for distributions made during the period 1958 through 1962.

Sec. 1901(a)(99) (amends sec. 812 of the Code)—operations loss deduction

This amendment strikes out obsolete transitional rules relating to years before 1958 to which operating losses of a life insurance company could be carried. An obsolete internal effective date (taxable years beginning after December 31, 1958) is also deleted.

Sec. 1901(a)(100) (amends sec. 817 of the Code)—rules relating to certain gains and losses

These amendments strike out special rules relating to capital losses of life insurance companies incurred in taxable years beginning before January 1, 1959, and reinsurance transactions of life insurance companies occurring in 1958.

Sec. 1901(a)(101) (amends sec. 818 of the Code)—accounting provisions

This amendment deletes transitional rules applicable to changes in a life insurance company's method of accounting from its taxable year 1957 to its taxable year 1958.

Sec. 1901(a)(102) (amends sec. 819 of the Code)—foreign life insurance companies

Subparagraph (A) strikes out a transitional rule for taxable years beginning before January 1, 1959.

Subparagraphs (B) and (C) make internal conforming amendments.

Sec. 1901(a)(103) (amends sec. 820 of the Code)—optional treatment of certain reinsurance policies

These amendments delete an obsolete provision relating to a life insurance company's treatment of a reimbursement of Federal income tax for a taxable year beginning before 1958.

Sec. 1901(a)(104) (amends sec. 821 of the Code)—tax on mutual insurance companies

Subparagraphs (A) and (B) strike out obsolete internal effective dates (taxable years beginning after December 31, 1963), relating to the imposition of tax.

Subparagraph (C) strikes out an obsolete transitional rule for taxable years beginning after December 31, 1962, and before January 1, 1968, relating to underwriting losses of mutual insurance companies.

Sec. 1901(a)(105) (amends sec. 822 of the Code)—determination of taxable investment income

Subparagraph (A) strikes out an obsolete reference to tax-exempt income from obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer. No such obligations that pay tax-exempt interest are outstanding.

Subparagraph (B) strikes out an obsolete internal effective date (taxable years beginning after December 31, 1962) relating to accrual of discount on bonds.

Sec. 1901(a)(106) (amends sec. 825 of the Code)—unused loss deductions

These amendments strike out an obsolete transitional date (taxable years beginning before January 1, 1963) relating to taxable years to which or from which certain unused losses may be carried.

Sec. 1901(a)(107) (amends sec. 831 of the Code)—tax on certain insurance companies

This amendment makes a clerical change, changing the word "or" to "on".

Sec. 1901(a)(108) (amends sec. 832 of the Code)—insurance company taxable income

These amendments conform the name of the National Association of Insurance Commissioners by substituting "Association" for "Convention."

Subchapter M. Regulated investment companies and real estate investment trusts

Sec. 1901(a)(109) (amends sec. 851 of the Code)—definition of regulated investment company

Subparagraph (A) makes a clerical change to conform a citation to other citations in the Code.

Subparagraph (B) strikes out an obsolete effective date (taxable years beginning after December 31, 1941) relating to the time for making an election to be a regulated investment company.

Sec. 1901(a)(110) (amends sec. 852 of the Code)—taxation of regulated investment companies and their shareholders

Subparagraph (A) strikes out a special rule, relating to the deduction for dividends paid, that applies only to taxable years beginning before January 1, 1975.

Subparagraph (B) deletes a transitional rule relating to an adjustment of the basis of the shares of a shareholder of a regulated investment company based upon a percentage of the amount of undistributed capital gains includible in the shareholder's income. The amendment deletes provisions relating to taxable years beginning before January 1, 1971. A special rule is provided so that the amendment made by subparagraph (B) shall not be considered to affect the amount of any increase in the basis of stock under the provisions of section 852(b)(3)(D)(iii) of the Code which is based upon amounts subject to tax under section 1201 of the Code in taxable years beginning before January 1, 1975.

Subparagraph (C) adds a citation reference to the United States Code.

Sec. 1901(a)(111) (amends sec. 856 of the Code)—definition of real estate investment trust

Subparagraph (A) strikes out an obsolete internal effective date (taxable years beginning after December 31, 1960) relating to an election to be a real estate investment trust.

Subparagraph (B) inserts a citation reference to the United States Code.

Sec. 1901(a)(112) (amends sec. 857 of the Code)—taxation of real estate investment trusts and their beneficiaries

This amendment strikes out a special rule, relating to the determination of the deduction for dividends paid, for taxable years beginning before January 1, 1975.

Subchapter N. Tax based on income from sources within or without the United States

Sec. 1901(a)(113) (amends sec. 864 of the Code)—definitions

These amendments and conforming amendments change the terms "sale" and "sold" to "sale or exchange" and "sold or exchanged" respectively each place they appear in part I of subchapter N of chapter 1 of the Code. Definitions of the term "sale" as including "exchange" and "sold" as including "exchanged" are then eliminated from section 864.

Sec. 1901(a)(114) (amends sec. 905 of the Code)—proof of foreign tax credits

This amendment deletes a special foreign tax credit relating to the treatment of taxes imposed by the United Kingdom with respect to scientific and industrial royalties. The treatment of these taxes is dealt with in the United States—United Kingdom income tax convention and accordingly the special Code provision is no longer necessary.

Sec. 1901(a)(115) (amends sec. 911 of the code)—taxation of noncash remuneration from sources without the United States

This amendment strikes out obsolete rules dealing with certain noncash remuneration received in taxable years ending in 1963, 1964, or 1965.

Sec. 1901(a)(116) (amends sec. 921 of the Code)—Western Hemisphere Trade Corporations

This amendment strikes out an obsolete provision relating to the determination of whether corporations met certain requirements of the 1939 Code in taxable years beginning before January 1, 1954.

Sec. 1901(a)(117) (amends sec. 931 of the Code)—income from sources within United States possessions

These amendments strike out an obsolete provision relating to citizens who were captured by the Japanese in the Philippine Islands during World War II.

Sec. 1901(a)(118) (amends sec. 934 of the Code)—tax liability incurred to the Virgin Islands

This amendment strikes out a provision indicating that amounts received within the United States cannot be excluded from income by Virgin Island law pursuant to section 934. This was originally intended as a source of payment rule, but, as a result of misinterpretations, it no longer serves any purpose in tax law.

Sec. 1901(a)(119) (amends sec. 951 of the Code)—amounts included in gross income of United States shareholders

This amendment strikes out an obsolete effective date provision (taxable years beginning after December 31, 1962) for this section.

Sec. 1901(a)(120) (repeals sec. 972 of the Code)—consolidation of group of export corporations

This paragraph repeals the provision which allows the consolidation of export trade corporations for purposes of the exception from subpart F treatment (relating to certain income of controlled foreign corporations) which is provided for certain export-related income of these corporations. This provision has been little used in the past and is not currently being used.

Subchapter O. Gain or loss on disposition of property

Sec. 1901(a)(121) (amends sec. 1001 of the Code)—determination of amount of and recognition of gain and loss

This amendment transfers to section 1001(c) of the Code the rules relating to recognition of gain or loss now in section 1002 of the Code. A conforming amendment repeals section 1002.

Sec. 1901(a)(122) (amends sec. 1015 of the Code)—basis of property acquired by gifts and transfers in trust

These amendments substitute "September 2, 1958" for the references to "the date of the amendment of the Technical Amendments Act of 1958" as the effective date of section 1015(d).

Sec. 1901(a)(123) (amends sec. 1016 of the Code)—adjustments to basis

This amendment deletes from the Code section 1016(a)(19), which requires adjustments in the basis of section 38 property in tax years beginning before 1965. To the extent future transactions involve property as to which taxpayers failed to make these pre-1965 basis adjustments, the repeal of section 1016(a)(19) does not prevent their doing so retroactively, at least for prospective application, since the law governing adjustment of basis is the law of the period during which the adjustment was required to be made. (See, e.g., Treas. Regs. § 1.1016–3(f).)

Sec. 1901(a)(124) (amends sec. 1018 of the Code)—adjustment of capital structure before September 22, 1938

This amendment strikes out an unnecessary citation.

Sec. 1901(a)(125) (repeals sec. 1020 of the Code)—election in respect of depreciation allowed before 1952

This amendment repeals an obsolete provision relating to an election to adjust the basis of property with respect to depreciation before 1952. No election could be made or revoked under this section after December 31, 1954. The adjustment under section 1016 of the Code to the basis of the property which was the subject of the election is not affected by prospective repeal of section 1020.

Sec. 1901(a)(126) (repeals sec. 1022 of the Code)—basis of certain foreign personal holding company stock

Section 1022 of the Code is repealed because it is an unimportant and seldom used provision. This provision was added to the Code for one case (in which it was not used). Section 1022 applies only with respect to the basis of stock or securities of a corporation which was a foreign personal holding company for its most recent taxable year ending before the death of a decedent dying after December 31, 1963, from whom such stock or securities are acquired. Although it is unlikely that this provision has ever been used, a special effective date is provided so that the repeal applies only with respect to stock or securities acquired from a decedent dying after the date of the enactment of this bill.

Sec. 1901(a)(127) (amends sec. 1024 of the Code)—cross references

This amendment strikes out an absolete reference to the Defense Production Act of 1950.

Sec. 1901(a)(128) (amends sec. 1033 of the Code)—involuntary conversions

Subparagraph (A) strikes out an obsolete provision applicable to the conversion of property into money where the disposition of the converted property occurred before 1951.

Subparagraphs (B) and (D) conform sections 1033(a)(2) and (c) to the change made by subparagraph (A). Subparagraph (B) also makes a clerical change to include as new subparagraphs necessary definitions of "control" and "disposition of the converted property" that would otherwise be deleted by the amendment made by subparagraph (A).

Subparagraph (C) strikes out an obsolete special rule relating to certain conversions of property before January 1, 1954.

Subparagraph (E) strikes out an obsolete effective date provision (December 31, 1957) relating to the disposition of certain property.

Subparagraph (F) conforms section 1033(g)(4) (added by section 2140(a) of the Act) to the amendment made by subparagraph (A).

Sec. 1901(a)(129) (amends sec. 1034 of the Code)—sale or exchange of residence

Subparagraphs (A) and (B) strike out obsolete internal effective dates (December 31, 1954) relating to the sale of a residence.

Subparagraph (C) strikes out an obsolete reference to the Internal Revenue Code of 1939.

Subparagraph (D) strikes out obsolete transitional rules for the years 1951 through 1957.

Subparagraph (E) strikes out an internal effective date (December 31, 1950) which is no longer needed.

Sec. 1901(a)(130) (amends sec. 1037 of the Code)—certain exchanges of United States obligations

This amendment corrects an erroneous cross reference.

Sec. 1901(a)(131) (amends sec. 1051 of the Code)—property acquired during affiliation

This amendment strikes out the sentences in section 1051 that provide that the basis of property acquired or held during a consolidated return year is to be determined under the consolidated return regulations. This provision is unnecessary because adequate authority for providing basis rules in the consolidated return regulations is provided under section 1502 and its predecessors.

Sec. 1901(a)(132) (amends sec. 1081 of the Code)—distributions required by the Securities and Exchange Commission

These amendments strike out a special rule for distributions of stock and rights to acquire stock before January 1, 1958, in pursuance of an order of the Securities and Exchange Commission.

Subparagraph (B) also conforms a citation to current practice.

Sec. 1901(a)(133) (amends sec. 1083 of the Code)—containing definitions of terms

These amendments eliminate unnecessary citations.

Sec. 1901(a)(134) (repeals sec. 1111 of the Code)—distribution of stock pursuant to order enforcing the antitrust laws

This amendment and conforming amendments repeal special provisions relating to the income tax treatment of certain recipients of General Motors stock distributed pursuant to a court order in the *DuPont* anti-trust case (*United States* v. *E. I. duPont deNemours and Company, et al.*, 353 U.S. 586 (1957) and 365 U.S. 806 (1961). Section 1111 of the Code provides special rules for individual shareholders and shareholders not entitled to the corporate dividends received deduction who receive such stock. Technical amendments relating to the addition of section 1111 were added to sections 301, 312, 535, 543, 545, 553, 556, and 561 of the Code. The distributions which are the subject of these provisions have been completed and the rights of persons who received such distributions are preserved. Accordingly, the bill repeals section 1111 of the Code and related provisions.

The repeal of these provisions is not retroactive. Nor do these repeals alter the determinations, for purposes of future years, of the basis of stock with respect to which the distributions were made.

Subchapter P. Capital gains

Sec. 1901(a)(135) (amends sec. 1201 of the Code)—alternative tax on capital gains

Subparagraph (A) makes clerical amendments to eliminate references to "net section 1201 gain" in taking advantage of the new definition of "net capital gain" (sec. 1901(a)(136)(B) of this title. This subparagraph also deletes transitional rules for computing the capital gains tax for corporations before 1975. (The effective date rule of the bill will preserve rights and liabilities with respect to pre-1975 years so long as they are open under the statute of limitations.)

Subparagraph (B) also eliminates references to "net section 1201 gain" made obsolete by the new definition of "net capital gain." In addition, obsolete transitional rules for computing an individual's alternative capital gains tax in 1970 and 1971 are deleted.

Subparagraph (C) eliminates other transitional rules for noncorporate taxpayers with respect to years prior to 1975. That elimination, and a transfer to section 1201(b) of the rule limiting to 25 percent the alternative tax on the first $50,000 of net capital gain permits subsection (d) to be deleted.

Sec. 1901(a)(136) (amends sec. 1222 of the Code)—terms relating to capital gains and losses

Subparagraph (A) defines a new term, "capital gain net income," which replaces the former term "net capital gain." The new term, like the former term, refers to the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges (sec. 1222(9)).

Subparagraph (B) sets forth a new definition of "net capital gain". The term replaces the existing term, "net section 1201 gain," in section 1222(11). The new and former terms refer to the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year. These definitions make it possible to use these terms throughout the Code instead of the longer phrases.

Sec. 1901(a)(137) (amends sec. 1233 of the Code)—gains and losses from short sales

This amendment substitutes "August 16, 1954" for "the date of enactment of this title" as the effective date of section 1233(c).

Sec. 1901(a)(138) (amends sec. 1237 of the Code)—real property subdivided for sale

This amendment strikes out an obsolete effective date (December 31, 1953).

Sec. 1901(a)(139) (repeals sec. 1240 of the Code)—taxability to employee of certain termination payments

This amendment repeals the so-called Louis B. Mayer provisions. This provision permits capital gain treatment of a lump sum settlement of rights in an employment contract. Since the provision contains narrow restrictions, including the requirement that the rights be created before August 16, 1954, it is believed that it has no applicability today.

Sec. 1901(a)(140) (amends sec. 1245 of the Code)—gain from dispositions of certain depreciable property

This amendment deletes surplus language added through a clerical error by Public Law 94–81.

Sec. 1901(a)(141) (amends sec. 1246 of the Code)—gain on foreign investment company stock

This amendment strikes out an obsolete effective date (December 31, 1962).

Subchapter Q. Readjustment of tax between years and special limitations

Sec. 1901(a)(142) (amends sec. 1311 of the Code)—mitigation of effect of limitations

These amendments conform section 1311 to the new name of the Tax Court.

Sec. 1901(a)(143) (repeals sec. 1315 of the Code)—effective date

This provision repeals the obsolete effective date provision (November 15, 1954) for part II of subchapter Q of chapter 1. An obsolete transitional rule relating to the application of the Internal Revenue Code of 1939 to certain determinations made before November 15, 1954, is also deleted.

Sec. 1901(a)(144) (repeals sec. 1321 of the Code)—involuntary liquidation of LIFO inventories

This paragraph repeals an obsolete provision relating to involuntary liquidations of LIFO inventories. The provision applies only to inventories liquidated in taxable years ending after June 30, 1950, and before January 1, 1955, and only if the inventory was replaced in a taxable year ending before January 1, 1956.

Sec. 1901(a)(145) (repeals sections 1331 through 1337 of the Code)—war loss recoveries

This provision repeals the provisions dealing with World War II war loss recoveries effective with respect to recoveries in taxable years beginning after December 31, 1976. The basis of property recovered during prior taxable years will not be affected by the repeal. Future recoveries, which appear unlikely, would be covered by the general tax benefit rule, which accords similar (though not identical) treatment.

Sec. 1901(a)(146) (amends sec. 1341 of the Code)—restoration of amount held under claim of right

This amendment strikes out provisions relating to certain retroactive payments by a subcontractor to a prime contractor, or by a subcontractor to a higher tier subcontractor. These provisions are expressly limited to payments made under a subcontract entered into before January 1, 1958, and it is believed that no such contracts are still outstanding.

Sec. 1901(a)(147) (repeals sec. 1342 of the Code)—computation of tax on certain amounts recovered as a result of a patent infringement suit

This paragraph repeals special provisions relating to amounts taken into gross income because of the reversal of a lower court decision in a patent infringement suit. Because of the narrow circumstances in which this provision applies (e.g., the lower court decision must be reversed on the ground that such decision was induced by fraud or undue influence), this provision is rarely used.

Sec. 1901(c)(148) (repeals sec. 1346 of the Code)—recovery of unconstitutional Federal taxes

This provision repeals special provisions, no longer needed, relating to the treatment of a recovery during the taxable year of a tax imposed by the United States which has been held unconstitutional.

Subchapter S. Election of certain small business corporations as to taxable income

Sec. 1901(a)(149) (amends sec. 1372 of the Code)—election by small business corporation

Under the minimum tax provisions of the Tax Reform Act of 1969, an electing small business corporation is subject to tax on certain capital gains. The amendment made by subparagraph A conforms section 1372 to these provisions by inserting a reference to the tax imposed by section 56 of the Code.

Subparagraph (B) strikes out a transitional rule, relating to the time for making an election by a small business corporation, that applies to a taxable year beginning in 1958.

Subparagraph (C) strikes out a special rule that allowed certain shareholders who owned stock that was community property to file a consent prior to May 15, 1961, to an election by a small business corporation.

Sec. 1901(a)(150) (amends sec. 1374 of the Code)—net operating losses of electing small business corporations

These amendments repeal an obsolete rule relating to carrybacks to years before 1958 of the net operating loss of an electing small business corporation by striking out section 1374(d). A rule of current application now in section 1374(d)(1) is transferred to section 1374(b).

Sec. 1901(a)(151) (amends sec. 1375 of the Code)—special rules applicable to distributions of electing small business corporations

Subparagraph (A) provides a new heading for subsection 1375(b) to reflect the fact that individuals no longer receive a dividends received credit.

Subparagraph (B) strikes out a reference to a subsection of section 1375 that was eliminated in 1966 by Public Law 89–389.

Sec. 1901(a)(152) (amends sec. 1378 of the Code)—tax imposed on certain capital gains of electing small business corporations

This amendment strikes out a provision relating to the determination of the tax with respect to certain capital gains of an electing small business corporation for certain taxable years beginning before January 1, 1975.

Subchapter T. Cooperatives and their patrons

Sec. 1901(a)(153) (amends sec. 1388 of the Code)—patronage dividends

Subparagraph (A) strikes out "the date of the enactment of the Revenue Act of 1962" and substitutes the exact date, "October 16, 1962".

Subparagraph (B) strikes out "the date of the enactment of this subsection" and substitutes the exact date, "November 13, 1966".

Chapter 2. Tax on Self-Employment Income

Sec. 1901(a)(154) (amends sec. 1401 of the Code)—self-employment taxes

Subparagraph (A) deletes obsolete rules providing rates of self-employment tax (for old age, survivors, and disability insurance) for taxable years that began before 1973. Similarly, subparagraph (B) strikes out obsolete rules providing rates of self-employment tax for hospital insurance for taxable years that began prior to 1975. (However, the current rate of hospital insurance self-employment tax for years beginning in 1974 and ending in 1975 would be preserved through the operation of the effective date of this title.)

Sec. 1901(a)(155) (amends sec. 1402 of the Code)—definitions relating to the tax on self-employment income

Subparagraph (A) deletes provisions relating to the determination of self-employment income for taxable years beginning before January 1, 1975, that are no longer needed.

Subparagraph (B) deletes an obsolete provision relating to the treatment of certain remuneration erroneously reported as net earnings from self-employment for taxable years ending after 1954 and before 1962.

Subparagraph (C) strikes out a special rule which allowed a request for an exemption from the tax on self-employment income for a taxable year ending before December 31, 1967, to be filed on or before December 31, 1968. The general rule provides that such request must be filed by the due date of the return for the first taxable year in which the individual has self-employment income.

Chapter 3. Withholding of Tax on Nonresident Aliens and Foreign Corporations and Tax-Free Covenants

Sec. 1901(a)(156) (repeals sec. 1465 of the Code)—definition of withholding agent

This section repeals section 1465, which defines "withholding agent," since that term is defined in section 7701(a)(16).

Chapter 4. Rules Applicable to Recovery of Excessive Profits on Government Contracts

Sec. 1901(a)(157) (amends sec. 1481 of the Code)—mitigation of effect of renegotiation of government contracts

These amendments update section 1481 by deleting obsolete references to the Sixth Supplemental National Defense Appropriation Act and to the Renegotiation Act of 1948.

Chapter 6. Consolidated Returns

Sec. 1901(a)(158) (amends sec. 1551 of the Code)—disallowance of surtax exemption and accumulated earnings credit

This amendment corrects an erroneous cross reference.

Sec. 1901(a)(159) (amends sec. 1552 of the Code)—earnings and profits of members of an affiliated group

This amendment deletes the effective date for this provision ("taxable years beginning after December 31, 1953, and ending after the date of enactment of this title".)

Sec. 1901(b)—conforming and clerical amendments

Section 1901(b) of the bill makes a series of clerical and conforming amendments required by the amendments and repeals made by subsection 1901(a) of this title.

Sec. 1901(c)—amendments to provisions referring to Territories

This subsection of the bill strikes out references to "Territories" in Code sections 37, 105, 117, 162, 581, 801, 861, 1014, and 1221. The United States no longer has any Territories.

In general these amendments are not intended to affect rights existing under present law that were conferred because of Code provisions regarding Territories.

Sec. 1901(d)—effective date

This subsection of the bill provides that unless otherwise expressly provided the amendments made by section 1901 of this title shall apply with respect to taxable years beginning after December 31, 1976.

SEC. 1902. AMENDMENTS OF SUBTITLE B; ESTATE AND GIFT TAXES

Chapter 11. Estate Tax

Sec. 1902(a)(1) (amends sec. 2012 of the Code)—credit for gift tax

These amendments provide headings for several subsections and paragraphs in this section and also substitute a comma for a dash in conforming to generally accepted drafting style.

Sec. 1902(a)(2) (amends sec. 2013 of the Code)—credit for tax on prior transfers

These amendments strike out obsolete references to prior laws.

Sec. 1902(a)(3) (amends sec. 2038 of the Code)—revocable transfers

This amendment strikes out a provision of limited application which is no longer needed. (The provision relates to a decedent who has been under a mental disability for a continuous period since September, 1947, and has been unable to relinquish certain powers to alter or revoke an interest in property transferred by him.)

Sec. 1902(a)(4) (amends sec. 2055 of the Code)—transfers for public, charitable, and religious use

Subparagraph (A) strikes out a provision of limited application which is no longer needed. This provision deals with highly unique circumstances involving a bequest in trust, the income from which is payable for life to the decedent's surviving spouse (who must be over 80 years old at the decedent's death) if such surviving spouse has a power of appointment over the corpus of such trust exercisable by will in favor of, among others, certain charitable, religious, scientific, literary, or educational organizations. No part of the corpus of such trust may be distributed to a beneficiary during the life of such surviving spouse and the surviving spouse must execute an affidavit within 6 months after the decedent's death specifying the organizations in favor of whom the power will be exercised (and the amount or proportion each is to receive). If the power of appointment is exercised in accordance with such affidavit, then the bequest in trust, reduced by the value of the life estate, shall, to the extent the power is exercised in favor of such organizations, be deemed a transfer to those organizations by the decedent.

Subparagraph (B) strikes out several cross references that are no longer applicable and updates the remaining cross references.

Sec. 1902(a)(5) (amends sec. 2106 of the Code)—taxable estate

Subparagraph (A) strikes out several cross references which are no longer necessary.

Subparagraph (B) strikes out a provision that excludes from the taxable estate obligations issued by the United States before March 1, 1941, if held by a decedent who was not engaged in business in the United States at the time of his death. It is believed that no obligations issued by the United States before March 1, 1941, are still outstanding.

Sec. 1902(a)(6) (amends sec. 2107 and sec. 2108 of the Code)—estate tax on expatriates and application of pre-1967 estate tax provisions

These amendments substitute "November 13, 1966" for "the date of enactment of this section" as the effective date of these provisions.

Sec. 1902(a)(7) (relates to sec. 2201 of the Code)—members of the Armed Forces dying during an induction period

In Public Law 93–597, section 6(b)(1) thereof provided for the amendment of section 2210 of the Code. There was no section 2210 of the Code, nor is there such a section now. The amendment was intended to be to section 2201 of the Code. This paragraph of the amendment corrects Public Law 93–597.

Sec. 1902(a)(8) (repeals sec. 2202 of the Code)—missionaries in foreign service

The bill repeals section 2202 of the Code, which provides that missionaries dying in missionary service will be presumed to die as United States residents, even if they intended to remain permanently in foreign service. Thus provision is now unnecessary since the Foreign Investors Tax Act of 1966 increased the estate tax exemption of nonresidents from $2,000 to $30,000.

Sec. 1902(a)(9) (amends sec. 2204 of the Code)—discharge of fiduciary from personal liability

This amendment corrects a typographical error in the Excise, Estate, and Gift Tax Adjustment Act of 1970.

Chapter 12. Gift Tax

Sec. 1902(a)(10) (amends sec. 2501 of the Code)—imposition of gift tax

This amendment strikes out an internal effective date (the first calendar quarter of 1971) which is no longer needed.

Sec. 1902(a)(11) (amends sec. 2522 of the Code)—cross references

This amendment strikes out a list of cross references which also appears in section 2055(f) of the Code and inserts in lieu of such list a reference to section 2055(f).

Sec. 1902(a)(12) (amends secs. 2011, 2016, 2053, 2055, 2056, 2106, 2522, and 2523 of the Code)—Territories

These sections are each amended by striking out references to Territories because there are no longer any United States Territories. Hawaii, admitted to Statehood in 1958, was the last Territory. There are United States territories (in which instances the word "territory" is begun with a small letter "t"), of which American Samoa is an example. In contrast to Territories, territories are unincorporated.

Sec. 1902(b)—conforming amendments

This subsection of the bill makes conforming amendments to the table of sections for subchapter C of chapter 11, and to sections 6503(e) and 6167(h)(2) of the Code to reflect the repeal of section 2202 and the amendment of section 2055 of the Code.

Sec. 1902(c)—effective dates

This subsection provides that the amendments made by paragraphs (1) through (8), and paragraphs (12) (A), (B), and (C) of subsection (a), as well as by subsection (b), shall apply in the case of estates of decedents dying after the date of enactment of the bill, and the amendment made by paragraph (9) of subsection (a) shall apply in the case of estates of decedents dying after December 31, 1970. The amendment made by paragraphs (10), (11), and (12) (D) and (E) of subsection (a) shall apply to gifts made after December 31, 1976.

SEC. 1903. AMENDMENTS OF SUBTITLE C; EMPLOYMENT TAXES

Chapter 21. Federal Insurance Contributions Act

Sec. 1903(a)(1) (amends secs. 3101 and 3111 of the Code)—rates of tax on employees and employers

Subparagraph (A) strikes out the employment tax rates for employees and employers for calendar years before 1975. These rates are not effective for calendar years after 1974.

Subparagraph (B) strikes out the pre-1975 tax rates on employers and employees for hospital insurance for the same reason.

Sec. 1903(a)(2) (repeals sec. 3113 of the Code)—application of social security tax to District of Columbia Credit Unions

This amendment repeals a provision relating to credit unions that were chartered under the Act of June 23, 1932. No credit unions are now chartered under that Act. District of Columbia Credit Unions are now Federal Credit Unions and as such are subject to section 3121 (b)(6)(B)(ii) of the Code.

Sec. 1903(a)(3) (amends sec. 3121 of the Code)—employment tax definitions

Subparagraph (A) strikes out a reference to the Internal Revenue Code of 1939 that is no longer needed, and also eliminates an obsolete internal effective date provision ("service performed after 1954").

Subparagraphs (B) and (D) eliminate unnecessary citations.

Subparagraph (C) changes the term "Secretary of the Treasury" to "Secretary of Transportation" in a provision pertaining to the Coast Guard. The Coast Guard is now within the Department of Transportation.

Subparagraph (E) deletes provisions allowing certain exempt organizations which filed certificates before 1966 or between 1955 and August 28, 1958 (relating to social security coverage for their employees), to amend the certificate to advance an effective date, or to request that the effective date be advanced, if the amendment was made before 1967, or if the request was made before 1960, respectively.

Subparagraphs (F) and (G) strike out obsolete effective dates (January 1, 1955, and December, 1956) relating to agreements entered into by domestic corporations with respect to certain social security coverage for employees of foreign subsidiaries and to service performed as a member of the uniformed services, respectively.

Sec. 1903(a)(4) (amends sec. 3122 of the Code)—Federal service

These amendments change references to the "Secretary of the Treasury" to the "Secretary of Transportation" in provisions relating to the Coast Guard, since the Coast Guard is now part of the Department of Transportation.

Sec. 1903(a)(5) (amends sec. 3125 of the Code)—returns in the case of certain governmental employees

This is a clerical amendment changing "Commissioners of the District of Columbia" to "Mayor of the District of Columbia" in order to conform to the District of Columbia Self Government and Governmental Reorganization Act.

Chapter 22. Railroad Retirement Tax Act

Sec. 1903(a)(6) (amends sec. 3201 of the Code)—rate of tax on railroad employees

These amendments strike out an effective date (September 30, 1973) relating to the imposition of taxes with respect to services performed after that date, and delete references to the Internal Revenue Code of 1954 which are not needed.

Sec. 1903(a)(7) (amends sec. 3202 of the Code)—deductions of tax from compensation

Subparagraph (A) strikes out an internal effective date (September 30, 1973) relating to the performance of services by employees after that date and also deletes references to the Internal Revenue Code of 1954 which are not needed.

Subparagraph (B) makes a clarifying change in language with respect to indemnification of an employee.

Sec. 1903(a)(8) (amends. sec. 3211 of the Code)—rate of tax on employee representatives

These amendments correct a grammatical error, delete references to the Internal Revenue Code of 1954 which are not needed, and strike out an obsolete effective date (September 30, 1973).

Sec. 1903(a)(9) (amends sec. 3221 of the Code)—rate of tax on employers

Subparagraphs (A) and (B) strike out an internal effective date (September 30, 1973) relating to the imposition of taxes with respect to services performed after that date, and also delete references to the Internal Revenue Code of 1954 which are no longer needed.

Subparagraph (C) deletes references to rates of tax applicable for services rendered before April 1, 1970.

Sec. 1903(a)(10) (amends sec. 3231 of the Code)—definitions

This amendment deletes unnecessary Statutes at Large citations.

Chapter 23. Federal Unemployment Tax Act

Sec. 1903(a)(11) (amends sec. 3301 of the Code)—Federal unemployment tax rate

These amendments strike out an internal effective date (calendar year 1970) and the tax rate with respect to wages paid during calendar year 1973, which are no longer needed.

Sec. 1903(a)(12) (amends sec. 3302 of the Code)—credits against tax

Subparagraphs (A) and (B) strike out references to special transitional rules relating to the 10-month period ending October 31, 1972, which are deleted by sections 1903(a)(14)(B) and 1903(a)(13) of this title.

Subparagraph (C)(i) strikes out a transitional provision relating to a limitation on credits against the unemployment tax if a State has not yet repaid an advance under certain prior laws. This provision is no longer applicable since all the States have repaid the advances made under those laws.

Subparagraph (C)(ii) strikes out an internal effective date (the date of enactment of the Employment Security Act of 1960) which is no longer needed. Subparagraphs (C)(iii), (C)(iv), (C)(v), and (C)(vi) are in the nature of amendments conforming to the amendment made by subparagraph (C)(i).

Subparagraph (D) strikes out a cross reference to a 1958 statute (the Temporary Unemployment Compensation Act of 1958) which is no longer applicable.

Sec. 1903(a)(13) (amends sec. 3303 of the Code)—conditions of additional credit allowance

This amendment deletes a transitional rule (from provisions relating to a finding by the Secretary of Labor with respect to certain State unemployment funds) for the 10-month period ending October 31, 1972.

Sec. 1903(a)(14) (amends sec. 3304 of the Code)—approval of State laws

Subparagraph (A) deletes an unnecessary citation. Subparagraph (B) eliminates a transitional rule regarding the 10-month period ending October 31, 1972.

Section 1903(a)(15) (amends sec. 3305 of the Code)—applicability of State law

Subparagraphs (A) and (B) strike out an obsolete effective date (July 1, 1953) which relates to service performed on or after that date.

Subparagraph (C) strikes out an obsolete effective date (December 31, 1971) relating to taxes imposed with respect to taxable years after that date.

Sec. 1903(a)(16) (amends sec. 3306 of the Code)—definitions

Subparagraphs (A), (B), and (C) strike out unnecessary citation references and insert a reference to the United States Code.

Subparagraph (D) strikes out an obsolete effective date (July 1, 1953) relating to services performed on or after such date.

Chapter 24. Collection of Income Tax at Source on Wages

Sec. 1903(a)(17) (amends sec. 3402 of the Code)—income tax collected at the source

This paragraph is a clerical amendment to correct an erroneous cross reference.

Sec. 1903(b)—conforming amendment

This amendment conforms the table of sections for subchapter (B) of chapter 21 to the repeal of section 3113.

Sec. 1903(c)—amendments to provisions relating to Territories

This amendment strikes out references to Territories in sections 3401 and 3404 of the Code because there are no longer Territories of the United States.

Sec. 1903(d)—effective date

The amendments made by section 1903 of the bill are to apply with respect to wages paid after December 31, 1976, except that the amendments made to chapter 22 of the Code are to apply with respect to compensation paid for services rendered after December 31, 1976.

SEC. 1904. AMENDMENTS OF SUBTITLE D; MISCELLANEOUS TAXES

Chapter 31. Retailers Excise Taxes

Sec. 1904(a)(1) (amends chapter 31 of the Code)—retailers excise taxes

Subparagraph (A) changes the title of chapter 31 from "Retailers Excise Taxes" to "Special Fuels" and strikes out obsolete tables of subchapters and sections since the whole chapter, as revised, will now have only one section.

Subparagraph (B) incorporates into section 4041(g) (relating to exemptions from fuel taxes) the existing provisions for exemptions from fuel taxes for State and local governments, sales for export or shipment to possessions, and nonprofit educational organizations now found in sections 4055, 4056, and 4057 of the Code. Code sections 4055, 4056, and 4057 are repealed by subparagraph (D) of this subsection of the bill.

Subparagraph (C) amends section 4041 of the Code by adding a new subsection (i) which incorporates the provisions of existing Code section 4054 (relating to sales by the United States). Section 4054 is repealed by subparagraph (D) of this subsection of the bill.

Subparagraph (D) repeals Code section 4042 (a cross reference), 4054, 4055, 4056, 4057 (the substance of which have been incorporated into Code sections 4041(i) and 4041(g) (2), (3), and (4), respectively, and 4058 (a cross reference).

Chapter 32. Manufacturers Excise Taxes

Sec. 1904(a)(2) (amends sec. 4216 of the Code)—definition of price

This paragraph is a clerical amendment redesignating subsections (e), (f), and (g) as subsections (d), (e), and (f), respectively. The previous subsection (d) was repealed in 1958.

Sec. 1904(a) (3) (amends sec. 4217 of the Code)—leases

This amendment strikes out a transitional rule for leases entered into before January 1, 1959, that are treated as sales subject to manufacturer's excise taxes.

Sec. 1904(a)(4) (repeals sec. 4226 of the Code)—floor stock taxes

This provision repeals floor stock tax provisions relating to specified items held in dealers' stocks on various past dates, the most recent of which are tires and tubes held by manufacturers' retail outlets on October 1, 1966.

Sec. 1904(a)(5) (amends sec. 4227 of the Code)—cross references

This amendment deletes two unnecessary cross references.

Chapter 33. Facilities and Services

Sec. 1904(a)(6) amends sec. 4253 of the Code)—exemptions from the tax on communications services

This amendment transfers to section 4253 of the Code (relating to exemptions) provisions for exemptions for communications services provided by section 4292 of the Code for State and local governments and by section 4294 for nonprofit educational organizations. Sections 4292 and 4294 are repealed by sections 1904(a) (9) and (10) of this title.

Sec. 1904(a)(7) (amends sec. 4261 of the Code)—tax on transportation of persons by air

This amendment strikes out references to an obsolete internal effective date (June 30, 1970).

Sec. 1904(a)(8) (amends sec. 4271 of the Code)—tax on transportation of property by air

This amendment also strikes out a reference to the obsolete internal effective date of June 30, 1970.

Sec. 1904(a)(9) (repeals sec. 4292 of the Code)—exemption for State and local governments from the communications services tax

This amendment repeals the provisions relating to exemption of State and local governments from the tax on communications services. These provisions are transferred to section 4253 of the Code by section 1904(a)(6) of this title. Section 4253 is devoted to exemptions from the communications services tax.

Sec. 1904(a)(10) (repeals sec. 4294 of the Code)—exemption for nonprofit educational organizations

This amendment deletes the provisions conferring exemption from the tax on communications services to nonprofit educational organizations. These provisions are transferred by subsection 1904(a)(6) to section 4253 of the Code, which is devoted to exemptions from this tax.

Sec. 1904(a)(11) (repeals sec. 4295 of the Code)—cross reference

This amendment repeals an unnecessary cross reference.

Chapter 34. Documentary Stamp Taxes

Sec. 1904(a)(12) (amends chapter 34 of the Code)—documentary stamp taxes

This amendment changes the title of chapter 34 of the Code from "Documentary Stamp Taxes" to "Policies Issued by Foreign Insurers", strikes out obsolete tables of subchapters and sections, and revises the remaining provisions.

Section 4371 of the Code is amended to conform to the fact that the tax imposed by that section is now paid by return and not by stamp. Section 4372 is amended to include the pertinent provisions of present section 4382(a)(1) and to make internal conforming amendments.

New Code section 4373 corresponds to the present section 4373, except for the deletion of an obsolete reference to Territories.

New Code section 4374 corresponds to present Code section 4384 except that it is changed to reflect payment by return rather than by stamp.

Present Code sections 4374, 4375, 4382, and 4383 are repealed to reflect the change from stamps to returns and to reflect the repeal in 1965 of other documentary stamp taxes.

Present Code sections 4361, 4362, and 4363, relating to a tax on conveyances which expired on January 1, 1968, are repealed.

Chapter 36. Certain Other Excise Taxes

Sec. 1904(a)(13) (amends sec. 4493 of the Code)—certain persons engaged in foreign air commerce

These amendments strike out an internal effective date (July 1, 1970) relating to an election to pay a tentative tax with respect to taxable civil aircraft. They also strike out a transitional rule for a year beginning on July 1, 1970.

Chapter 37. Sugar, Coconut and Palm Oil

Sec. 1904(a)(14) (amends chapter 37 of the Code)—tax on sugar, coconut and palm oil

This amendment changes the title of chapter 37 from "Sugar, Coconut and Palm Oil" to "Sugar" to reflect the repeal in 1962 of taxes on coconut and palm oil. Obsolete tables of subchapters are also deleted.

Chapter 38. Import Taxes

Sec. 1904(a)(15) (repeals secs. 4591 through 4597 of the Code)—import taxes on oleomargarine

This provision strikes out provisions relating to taxes on imported oleomargarine. Requirements as to wholesomeness and purity are enforced by the Food and Drug Administration outside the requirements of the Internal Revenue Code. No taxes are collected under these provisions and at present they serve no internal revenue purpose. Since the other subchapters of this chapter were repealed in 1962, the entire chapter is now repealed.

Chapter 39. Regulatory Taxes

Sec. 1904(a)(16) (repeals secs. 4801 through 4806 of the Code)—tax on white phosphorous matches

This provision repeals provisions relating to taxes on white phosphorous matches. Any act taxable under these provisions is illegal under other provisions of Federal law and these provisions are not needed for effective enforcement. No tax is collected under these provisions.

Sec. 1904(a)(17) (repeals secs. 4811 through 4826 of the Code)—tax on adulterated butter

This amendment strikes out the tax on adulterated butter and related provisions. Requirements as to wholesomeness and purity of butter are enforced by the Food and Drug Administration outside the provisions of the Code. No taxes are collected as to adulterated butter. This tax dates from the 1890's, when it served the dual function of restricting trade in this item and insuring purity (e.g., restricting the use of rancid butter). At present, the tax and related provisions serve no internal revenue purpose. Appropriate regulation of commerce can be accomplished in other provisions of law.

Sec. 1904(a)(18) (repeals sec. 4881 through 4886 of the Code)—tax on circulation other than of national banks

This paragraph repeals provisions relating to circulation of other than national banks. The Comptroller of the Currency has stated that any act taxable under these provisions is also illegal under other provisions of Federal law and that these provisions are not needed for effective enforcement. No tax is collected under these provisions.

Chapter 40. General Provisions Relating to Occupational Taxes

Sec. 1904(a)(19) (amends sec. 4901 of the Code)—payment of occupational taxes

This amendment strikes out an obsolete provision relating to payment of certain occupational taxes by stamp, since all taxes to which this provision applies are paid by return.

Sec. 1904(a)(20) (amends sec. 4905 of the Code)—liability for occupational taxes in case of death or change in location

Section 4905 of the Code allows the wife (but not husband) of a decedent who paid a certain occupational tax before his death to carry on the same trade or business for the residue of the term for which the tax was paid without liability for additional tax. This amendment substitutes "spouse" for "wife" in this provision so that a widower will have the same privilege as a widow.

Chapter 41. Interest Equalization Tax

Sec. 1904(a)(21) (repeals secs. 4911 through 4931 of the Code)—interest equalization tax

This paragraph repeals provisions relating to the interest equalization tax, since this tax does not apply to acquisitions of stock and debt obligations made after June 30, 1974. A special effective date is provided so that the repeal of chapter 41 (Code sections 4911 through 4931) is to apply only with respect to acquisitions of stock and debt obligations made after June 30, 1974 (or to loans and commitments made after that date). Thus the rights and obligations of persons with respect to acquisitions of stock and debt obligations prior to July 1, 1974, are preserved.

Chapter 42. Private Foundations

Chapter 43. Qualified Pension, Etc., Plans

Sec. 1904(a)(23) (amends sec. 4973 of the Code)—tax on excess contributions to certain retirement plans

Subparagraph (A) corrects an error in margination. Subparagraph (B) corrects an erroneous reference. Both these errors were clerical errors in ERISA.

Sec. 1904(b)—conforming amendments

This subsection of the bill makes various conforming amendments to the amendments and repeals made by subsection (a). These amendments include repeal of several Code sections that relate to violations of laws and other offenses concerning oleomargarine or adulterated butter (Code sections 7234 and 7265), white phosphorus matches (Code sections 7239, 7267, 7274, and 7328), and adulterated butter and process or renovated butter (Code sections 7235 and 7264). Amendments conforming to the repeal of chapter 41 of the Code (relating to interest equalization taxes) include the repeal of Code sections 263(a)(3) and (d) (relating to the deduction of interest equalization taxes), 6011(d), 6076, 6651(e), 6680 (which relate to the filing requirements for interest equalization tax returns), 6611(h) (relating to interest on overpayments of interest equalization tax), 6681, 7241 (relating to false or fraudulent equalization tax certificates), and 6689 (relating to failure by certain foreign issuers and obligors to comply with United States investment equalization tax requirements).

The amendments conforming to the repeal of chapter 41 have various effective date provisions to assure that rights and liabilities (both civil and criminal) of taxpayers or other persons with respect to acquisitions of stock or indebtedness before July 1, 1974 (or certain actions with respect to such acquisitions), are not affected. Thus, for example, if a taxpayer is required to file an interest equalization tax return with respect to an acquisition of stock prior to July 1, 1974, and has failed to file such return, the repeal of section 6011(d) of the Code by this bill will not affect the requirement that such a return be filed.

Sec. 1904(c)—amendments to provisions referring to Territories

Subsection (c) amends Code section 4482(c)(1) by striking out a reference to Territories because the United States no longer has Territories.

Sec. 1904(d)—effective date

Subsection (d) provides that the amendments made by section 1904 (except as otherwise provided) shall take effect on the first day of the first month which begins more than 90 days after the date of enactment of the bill.

SEC. 1905. AMENDMENTS OF SUBTITLE E; ALCOHOL, TOBACCO, AND CERTAIN OTHER EXCISE TAXES

Chapter 51. Distilled Spirits, Wines, and Beer

Subchapter A. Gallonage taxes

Sec. 1905(a)(1) (amends sec. 5005 of the Code)—persons liable for tax on distilled spirits

This amendment strikes out provisions relating to an internal effective date (July 1, 1959) which are no longer needed.

Sec. 1905(a)(2) (amends sec. 5008 of the Code)—abatement, etc., of tax on distilled spirits in instances of loss or destruction

Present law provides relief (under sec. 5008) from the distilled spirits tax of section 5001 for voluntary destruction of the spirits on bonded premises or before the spirits are removed from the bottling premises. In instances of spirits already removed from bonded premises, tax relief is provided, under certain defined circumstances, for accidental destruction within the distilled spirits plant. Finally, tax relief is provided if spirits that have been withdrawn from bond (with tax determination or payment) are thereafter returned to the bonded premises for certain purposes specified in section 5215.

Because of a technical error, this relief is now provided only for the tax imposed on domestic distilled spirits under section 5001 or other provisions of Chapter 51 of the Code. Puerto Rico and Virgin Island spirits are taxed separately (under sec. 7652). A technical correction is included in the bill to give the same type of tax relief to Puerto Rican or Virgin Island spirits as is now given for domestic spirits.

This amendment also strikes out an obsolete internal effective date (July 1, 1959).

Sec. 1905(a)(3) (amends sec. 5009 of the Code)—drawback of tax

This amendment deletes a redundant citation.

Sec. 1905(a)(4) (amends sec. 5025 of the Code)—exemption from rectification tax

This amendment permits stabilization (without payment of rectification tax) preparatory to export, thereby giving distilled spirits to be exported the same treatment, in this instance, as is given to distilled spirits preparatory to bottling.

Sec. 1905(a)(5) (amends sec. 5054 of the Code)—stamps and other devices as evidence of payment of tax on beer

This amendment strikes out a beer stamp provision that has never been implemented and for which there is no intention of implementation.

Sec. 1905(a)(6) (amends sec. 5061 of the Code)—method of collecting tax

Subparagraph (A) strikes out a stamp tax requirement that is now obsolete in that the taxes to which it applies are now all paid by return.

Subparagraph (B) strikes out authority to use stamps, coupons, tickets, or tax-stamp machines as alternative methods of collecting alcohol taxes since those methods neither have been implemented nor are to be implemented. The amendment also provides that taxes on illegal items are to be due and payable immediately at the time given in the provisions imposing the taxes, or (if no specific time is provided) when the event referred to in the provision occurs, and that these taxes are to be assessed and collected in accordance with the rules regarding taxes payable by return but for which no return has been filed.

Subparagraph (C) strikes out a provision no longer needed because it applies only to the unusual methods of collection stricken from the statute by subparagraph (B). In its place is substituted a provision making it clear that the gallonage taxes on distilled spirits, rectification, wines, and beer are generally imposed in addition to import duties. This conforms to the Tariff Schedules.

Sec. 1905(a)(7) (amends sec. 5113 of the Code)—sales to limited retail dealers

This amendment conforms to section 1905(a)(10) of this title (amending section 5122(c) of the Code), which permits a limited retail dealer to deal in distilled spirits, as well as in wine and beer.

Sec. 1905(a)(8) (amends sec. 5117 of the Code)—prohibited purchases by dealers

This amendment provides that a limited retail dealer may now purchase distilled spirits from a retail dealer in liquors. This is another change in the nature of an amendment conforming to section 1905(a)(10) of the Act.

Sec. 1905(a)(9) (amends sec. 5121 of the Code)—imposition and rate of tax on retail dealers

This paragraph provides that a limited retail dealer in distilled spirits is to pay a special (occupational) tax of $4.50 per calendar month. This amendment is necessitated by the broadening of the definition of "limited retail dealer" in section 1905(a)(10) of this title to include limited retail dealers in distilled spirits.

Sec. 1905(a)(10) (amends sec. 5122 of the Code)—definition of limited retail dealer

This provision expands the definition of a limited retail dealer to include a limited retail dealer in distilled spirits, as well as in wine and beer.

Sec. 1905(a)(11) (amends sec. 5131 of the Code)—drawback of tax in event of nonbeverage uses

Section 5131 of the code permits drawback of distilled spirits tax if the spirits are put to cited nonbeverage uses. Section 5131 requires the spirits thus used, to be eligible for the drawback, to have been produced in a domestic registered distillery or industrial alcohol plant and withdrawn from bond, or to be spirits withdrawn from the bonded premises of a distilled spirits plant. Domestic distilled spirits used for the cited nonbeverage purposes must necessarily have been produced in a domestic registered distillery or industrial alcohol plant. Spirits so used may also have been imported or brought into the United States, but, if so, they need first have been transferred to the bonded premises of a distilled spirits plant before withdrawal for the nonbeverage uses. This amendment deletes the unnecessary requirement that spirits "imported" or "brought into" the United States must first be transferred to the bonded premises of a distilled spirits plant.

Sec. 1905(a)(12) (amends sec. 5142 of the Code)—payment of taxes

This amendment replaces existing provisions that occupational taxes be paid by stamp with a requirement that they be paid by return. These taxes are now, in fact, being paid by return, as is required by Treasury regulations. This amendment also makes it clear that the tax on stills and condensers imposed by section 5101 is to be paid by return.

Subchapter B. Qualification requirements for distilled spirits plants

Sec. 1905(a)(13) (amends sec. 5171 of the Code)—permits for distilled spirits plants

This amendment eliminates a transitional rule relating to the time in which qualified distillers, bonded warehousemen, rectifiers, and bottlers of distilled spirits doing business as such on June 30, 1959, could obtain the required permit to continue in business. In addition, a redundant citation is deleted.

Sec. 1905(a)(14) (amends sec. 5174 of the Code)—withdrawal bonds

This paragraph allows a proprietor of bottling premises to withdraw distilled spirits which have been bottled in bond to his bottling premises under his withdrawal bond. The change would permit greater convenience in handling of bottled in bond cased goods and allow the same tax payment procedures applicable to spirits bottled and cased on bottling premises to be applied to bottled in bond cased goods.

Subchapter C. Operation of distilled spirits plants

Sec. 1905(a) (15) (amends sec. 5232 of the Code)—transfer of distilled spirits from outside the United States

Under section 5314 of the Code, distilled spirits brought into the United States from Puerto Rico or the Virgin Islands are not treated as "imported," but rather as "brought into" the United States.

The first sentence of section 5232 of the Code permits spirits imported or brought into the United States in bulk containers to be withdrawn from customs custody and transferred to the bonded premises of a distilled spirits plant without payment of the internal revenue tax. The second sentence then transfers the liability for eventual payment of the tax from the "importer" to the operator of the distilled spirits plant. In order to coordinate the two sentences, this amendment amplifies the second sentence to extend relief from tax liability to persons who have brought such spirits into the United States.

Sec. 1905(a) (16) (amends sec. 5233 of the Code)—relating to bottling requirements

This amendment eliminates a redundant citation.

Sec. 1905(a) (17) (amends sec. 5234 of the Code)—consolidation for further storage in bond

This amendment conforms the time limit within which distilled spirits in bond storage may be mingled with the time limit in section 5006(a) (2) for storing distilled spirits in bond. The latter limit was raised from eight years to twenty years in 1958.

Subchapter E. General provisions relating to distilled spirits

Sec. 1905(a) (18) (amends sec. 5314 of the Code)—application of certain provisions to Puerto Rico

This provision corrects an erroneous cross reference.

Sec. 1905(a) (19) (repeals sec. 5315 of the Code)—status of certain distilled spirits on July 1, 1959

This paragraph repeals a July 1, 1959, transitional provision.

Subchapter F. Bonded and taxpaid wine premises

Sec. 1905(a) (20) (amends sec. 5368 of the Code)—gauging and marking wine

Subparagraph (A) eliminates a reference to stamps in the heading of section 5368 since stamps are not used to identify wines and the use of stamps is not contemplated.

Subparagraph (B) removes a reference to stamps in section 5368 (b) and in the heading of that subsection.

Sec. 1905(a)(23) (amends sec. 5685 of the Code)—penalties for pos-to taxation of wine

This amendment strikes out a citation that is redundant and unnecessary.

Subchapter J. Penalties, seizures, and forfeitures relating to liquors

Sec. 1905(a)(22) (amends sec. 5601 of the Code)—presumptions relating to criminal penalties

This amendment strikes out paragraphs (1), (3), and (4) of present section 5601(b)—presumptions which either have been specifically declared unconstitutional or which the Internal Revenue Service believes to be unconstitutional.

Sec. 1905(a)(23) (amends sec. 5685 of the Code)—penalties for possession of certain devices

This paragraph conforms cross references and a definition to changes in chapter 53 made by the Gun Control Act of 1968.

Chapter 52. Cigars, Cigarettes, and Cigarette Papers and Tubes

Sec. 1905(a)(24) (amends sec. 5701 of the Code)—rate of tax on imported tobacco products

This amendment conforms the tax on imported tobacco products and cigarette tubes and papers to Tariff Schedule item 804, 19 U.S.C. 1202, which provides, for articles previously exported from the United States, a customs duty "in lieu of any other duty or tax".

Sec. 1905(a)(25) (amends sec. 5703 of the Code)—liability for tobacco tax and method of payment

Subparagraph (A) conforms provisions relating to tobacco tax to administrative practice and to related provisions regarding wines and distilled spirits.

Subparagraph (B) strikes out a traditional rule allowing tobacco taxes to continue to be paid by stamp until regulations provide for payment on the basis of return. Those regulations have been issued, and so the transitional rule no longer applies.

Subparagraph (C) eliminates section 5703(c), relating to the use of stamps to evidence payment of the tobacco tax. These stamp provisions have never been implemented, and there is no intention to implement them.

Sec. 1905(a)(26) (amends sec. 5704 of the Code)—tobacco products, etc., brought into or returned to the United States

This amendment relaxes an unneeded restriction by permitting proprietors of export warehouses to import, under bond, tobacco products and cigarette papers and tubes directly, rather than through a tobacco products manufacturer, as is required by present law.

Sec. 1905(a)(27) (amends sec. 5712 of the Code)—tobacco business permits

This paragraph deletes an obsolete transitional rule allowing persons lawfully in business as a tobacco products manufacturer or as a tobacco export warehouse proprietor to remain in business after enactment of the Excise Tax Technical Changes Act of 1958 until he has had a reasonable opportunity to obtain the tobacco permit required by that Act.

Sec. 1905(a)(28) (amends sec. 5723 of the Code)—packaging tobacco prior to removal

This amendment strikes out a requirement that a tobacco products manufacturer or a tobacco export warehouse proprietor must affix to his package of tobacco products, etc., prior to removal, such stamps as regulations may prescribe. The use of stamps to evidence payment of the tobacco tax is being eliminated by the repeal of section 5703(c) of the Code by section 1905(a)(25)(C) of this title. Conforming changes are made to the headings of section 5723 and 5723(b).

Sec. 1905(b)—conforming and clerical amendments

This subsection provides various conforming amendments to reflect the amendments and repeals made in the alcohol, tobacco, etc., excise tax provisions (subtitle E).

Sec. 1905(c)—amendments to provisions referring to Territories

This subsection strikes out a number of references to "Territories" in the alcohol, tobacco, etc., tax provisions for the reason that there are no longer any "Territories" of the United States. Hawaii, which ceased to be a Territory in 1958, was the last. The United States does have a number of "territories" (spelled with a beginning small letter "t"), but they have never been affected by these provisions. Deletion of these references does not terminate the rights, duties, powers, and liabilities that arose before the effective date of this title.

Sec. 1905(d)—effective date

This subsection provides that the effective date of the amendments and repeals made to subtitle E is to be the first day of the first month beginning more than 90 days after enactment of this Act.

SEC. 1906. AMENDMENTS OF SUBTITLE F; PROCEDURE AND ADMINISTRATION

Chapter 61. Information and Returns

Sec. 1906(a)(1) (amends sec. 6013 of the Code)—joint returns

These amendments are clerical, such as the one which uses the new name of the United States Tax Court.

Sec. 1906(a)(2) (amends sec. 6015 of the Code)—estimated tax

This amendment strikes out an obsolete effective date provision (December 31, 1954) for this section.

Sec. 1906(a)(3) (amends sec. 6037 of the Code)—returns of subchapter S corporations

This amendment corrects an error in a cross reference.

Sec. 1906(a)(4) (amends sec. 6046 of the Code)—information as to organization of foreign corporations

This amendment eliminates special rules (relating to information returns with respect to foreign corporations) applicable to the first six months of 1963.

Sec. 1906(a)(5) (amends sec. 6051 of the Code)—receipts for employees

This is a clerical amendment striking out a misplaced word.

Sec. 1906(a)(6) (amends sec. 6065 of the Code)—verification of returns

This amendment eliminates the authority to require certain returns, statements, and other documents to be verified by oaths, rather than under the penalty of perjury. This authority is not now used and is not expected to be used.

Sec. 1906(a)(7) (repeals sec. 6105 of the Code)—compilation of data for certain excess profits cases

This amendment strikes out a provision for the compilation and publication of data with respect to excess profits tax cases under section 722 of the 1939 Code.

Sec. 1906(a)(8) (amends sec. 6111 of the Code)—cross reference

This amendment strikes out cross references to a provision relating to cotton futures (see section 1952 of this title) and to provisions relating to narcotics which were repealed by the Comprehensive Drug Abuse Prevention and Control Act of 1970.

Chapter 62. Time and Place for Paying Tax

Sec. 1906(a)(9) (amends sec. 6152 of the Code)—installment payments by corporations

This amendment strikes out a rule for taxable years ending before December 31, 1954, which allowed a corporation to pay taxes imposed by chapter 1 in four installments.

Sec. 1906(a)(10) (amends sec. 6154 of the Code)—installment payments of estimated income tax by corporations

These amendments strike out various transitional rules applicable to installments of estimated tax for taxable years beginning in 1968, 1969, 1970, 1971, 1972, 1973, and 1974.

Sec. 1906(a)(11) (amends sec. 6157 of the Code)—payment of Federal unemployment tax quarterly or on other basis

These amendments strike out special rules relating to the computation of Federal unemployment tax for calendar quarters or other periods in 1970 and 1971.

Sec. 1906(a)(12) (repeal of sec. 6162 of the Code)—extension of time for payment of tax on the liquidation of certain personal holding companies

This amendment repeals a section dealing with an extension of time for the payment of tax on gain on the liquidation before 1957 of certain personal holding companies.

Chapter 63. Assessment

Sec. 1906(a)(13) (amends sec. 6205 of the Code)—relating to the District of Columbia as an employer

This is a clerical amendment changing "Commissioner of the District of Columbia" to "Mayor of the District of Columbia" in order to reflect the enactment of the District of Columbia Self Government and Governmental Reorganization Act.

Sec. 1906(a)(14) (amends sec. 6207 of the Code)—cross references

The amendment strikes out a cross reference to provisions repealed in 1962.

Sec. 1906(a)(15) (amends sec. 6213 of the Code)—restrictions applicable to deficiencies; petitions to the Tax Court

This amendment conforms the provision to the definition of "United States", used in a geographical sense, that appears in section 7701 (a)(9) of the Code.

Sec. 1906(a)(16) (amends sec. 6215 of the Code)—assessment of deficiency found by Tax Court

This amendment strikes out an unnecessary citation.

Chapter 64. Collection

Sec. 1906(a)(17) (amends sec. 6302 of the Code)—collection of certain excise taxes

This is a clerical amendment to strike out references to certain obsolete provisions relating to taxes on coconut and palm oil (repealed in 1962) and on narcotics (repealed in 1970).

Sec. 1906(a)(18) (repeals sec. 6304 of the Code)—collection under the Tariff Act of 1930

This amendment repeals a cross reference to provisions repealed in 1962.

Sec. 1906(a)(19) (amends sec. 6313 of the Code)—fractional parts of a cent

This amendment deletes a reference to taxes payable by stamp from the rules pertaining to rounding off fractional parts of a cent in the payment of taxes, since no tax now collected by stamp will be due in fractions of a cent.

Sec. 1906(a)(20) (amends sec. 6326 of the Code)—cross references for sections relating to lien for taxes

This provision conforms to current drafting style in striking out unnecessary Statutes at Large citations in paragraphs 2, 3, 4, and 5.

Sec. 1906(a)(21) (amends sec. 6365 of the Code)—definitions and special rules

This amendment changes the term "Commissioner of the District of Columbia" to "Mayor of the District of Columbia" to reflect the provisions of the District of Columbia Self Government and Governmental Reorganization Act.

Chapter 65. Abatements, Credits, and Refunds

Sec. 1906(a)(22) (amends sec. 6412 of the Code)—floor stocks refunds

This is a clerical amendment which renumbers two paragraphs.

Sec. 1906(a)(22) (amends sec. 6413 of the Code)—special rules applicable to employment taxes

Subparagraphs (A) and (C) are clerical amendments substituting "Mayor" for "Commissioners" of the District of Columbia to reflect enactment of the District of Columbia Self Government and Governmental Reorganization Act.

Subparagraph (B) is a clerical amendment to reflect an increase in the social security wage base ceiling and to strike out certain rules applicable to special refunds or credits of certain employment taxes deducted from wages received in calendar years prior to 1975. A special effective date is provided so that refunds or credits with respect to wages paid in calendar years before 1977 will not be affected.

Subparagraph (D) strikes out an obsolete internal effective date (1967).

Sec. 1906(a)(24) (amends sec. 6416 of the Code)—refund or credit of taxes on special fuels

Subparagraph (A) is a clerical correction redesignating two subparagraphs in section 6416(a)(3).

Subparagraph (B) deletes provisions relating to credits or refunds of overpayments of taxes imposed on taxable sales or uses under section 4041 of the Code, but ultimately used or resold for exempt purposes (such as a use on a farm for farming purposes). These deleted provisions relate only to uses or resales prior to July 1, 1970. Exempt uses or resales after June 30, 1970, are covered by section 6427 of the Code.

Section 6416 of the Code allows a credit to be taken "on any subsequent return" for a number of overpayments, including those described in the deleted provisions of section 6416. It is possible, therefore, that claims for overpayments on account of sales and uses prior to July 1, 1970, may still be open, and, accordingly, the bill provides a special effective date for the deletions made in paragraph (B) to preserve any such claims that may still be open.

Sec. 1906(a)(25) (repeal of sec. 6417 of the Code)—coconut and palm oil

This amendment strikes out a section of the Code relating to the former tax on coconut and palm oil that was repealed in 1962.

Sec. 1906(a)(26) (amends sec. 6420 of the Code)—gasoline used on farms

Subparagraph (A) deletes obsolete provisions concerning claims for refund with respect to gasoline used before July 1, 1965.

Subparagraph (B) corrects a typographical error.

Subparagraphs (C) and (D) strike out obsolete effective date provisions (December 31, 1955, and June 30, 1965).

Sec. 1906(a)(27) (amends sec. 6421 of the Code)—gasoline used for nonhighway purposes or by local transit systems

Subparagraph (A) strikes out an obsolete internal effective date (June 30, 1970).

Subparagraph (B) deletes obsolete provisions relating to claims for refund with respect to gasoline used before July 1, 1965.

Subparagraphs (C) and (D) strike out obsolete internal effective dates (June 30, 1956, and June 30, 1965).

Sec. 1906(a)(28) (amends sec. 6422 of the Code)—cross references relating to credits and refunds

This amendment deletes unnecessary citations to the Statutes at Large.

Sec. 1906(a)(29) (amends sec. 6423 of the Code)—credit or refund of alcohol and tobacco taxes

These amendments delete obsolete internal effective dates (April 30, 1958, April 30, 1959, May 1, 1958, and June 15, 1957) relating to claims for credit or refund and suits filed with respect to alcohol and tobacco taxes.

Sec. 1906(a)(30) (amends sec. 6424 of the Code)—lubricating oil not used in highway motor vehicles

These amendments strike out a transitional rule for taxable years beginning in 1966 and an obsolete internal effective date (December 31, 1965) relating to the use of certain lubricating oil.

Sec. 1906(a)(31) (amends sec. 6427 or the Code)—fuels not used for taxable purposes

These amendments strike out an obsolete effective date (June 30, 1970) relating to repayment or credit of the tax on use of certain fuels.

A special effective date for this provision ("fuel used or resold after June 30, 1970") is provided because credits and refunds for fuels used or resold prior to July 1, 1970, are governed by section 6416(b) of the Code.

Chapter 66. Limitations

Sec. 1906(a)(32) (amends sec. 6504 of the Code)—cross references

Subparagraph (A) is a clerical amendment to combine several cross references into one paragraph. Subparagraph (B) renumbers the paragraphs of section 6504 of the Code in conformance with the amendment made by subparagraph (A) and the deletion of paragraphs (1), (6), and (7) by paragraphs (36)(C), (37)(D), and (39)(B) of section 1901(b) of this title.

Sec. 1906(a)(33) (amends sec. 6511 of the Code)—limitations on credit or refund

These amendments strike out obsolete internal effective date provisions (September 1, 1959, and December 31, 1965) relating to certain claims for credit or refund.

Chapter 67. Interest

Sec. 1906(a) (34) (amends sec. 6601 of the Code)—interest on underpayments

This amendment strikes out an obsolete reference to a provision of the 1939 Code relating to interest on estimated tax payments.

Chapter 68. Additions to the Tax, Additional Amounts, and Assessable Penalties

Sec. 1906(a)(35) (amends sec. 6654 of the Code)—payment of estimated income tax

This amendment strikes out an internal effective date (December 31, 1954) that is no longer needed.

Chapter 69. General Provisions Relating to Stamps

Sec. 1906(a)(36) (amends sec. 6802 of the Code)—supply and distribution of stamps

This paragraph is a clerical amendment substituting a period for a semicolon.

Sec. 1906(a)(37) (amends sec. 6803 of the Code)—accounting and safeguarding of stamps

These amendments redesignate subsections (b) (1) and (2) as subsections (a) and (b) (the previous subsection (a) having been repealed in 1972) and strike out an obsolete cross reference.

Chapter 70. Jeopardy, Bankruptcy, and Receiverships

Sec. 1906(a)(38) (amends sec. 6863 of the Code)—stay of collection of jeopardy assessments

This amendment strikes out an obsolete internal effective date (January 1, 1955) relating to a stay of sale of seized property pending a Tax Court decision.

Chapter 72. Licensing and Registration

Sec. 1906(a)(39) (amends sec. 7012 of the Code)—cross references

This amendment strikes out a cross reference to the tax on white phosphorous matches (which is repealed by section 1904(a)(16) of this title), corrects an erroneous cross reference, and renumbers the remaining subsections.

Chapter 73. Bonds

Sec. 1906(a)(40) (amends sec. 7103 of the Code)—cross references

This amendment strikes out cross references to taxes on oleomargarine, adulterated butter, filled cheese, opium for smoking, and white phosphorus matches repealed by sections 1904(a)(15), (16), and (17) of the Act and by legislation enacted in 1962, 1970, and 1974.

Chapter 75. Crimes, Other Offenses, and Forfeitures

Sec. 1906(a)(41) (amends sec. 7271 of the Code)—penalties for offense relating to stamps

This amendment strikes out an obsolete provision relating to payment of certain taxes by stamp.

Sec. 1906(a)(42) (amends sec. 7272 of the Code)—penalty for failure to register

This amendment strikes out cross references to narcotics provisions which were repealed by the Comprehensive Drug Abuse Prevention and Control Act of 1970.

Sec. 1906(a)(43) (amends sec. 7326 of the Code)—disposal of forfeited or abandoned property

These amendments correct an erroneous reference and redesignate subsection (c) as subsection (b), the previous subsection (b) having been repealed by the Comprehensive Drug Abuse Prevention and Control Act of 1970.

Chapter 76. Judicial Proceedings

Sec. 1906(a)(44) (amends sec. 7422 of the Code)—civil actions for refund

These amendments strike out an obsolete internal effective date (June 15, 1942), relating to the effect of certain suits and Tax Court petitions filed after that date.

Sec. 1906(a)(45) (amends sec. 7428 of the Code)—cross references relating to proceedings by taxpayers

Unnecessary Statutes at Large citations are struck out in this amendment.

Sec. 1906(a)(46) (amends sec. 7448 of the Code)—annuities to widows and dependent children of Tax Court judges

These amendments eliminate a distinction in present law between male and female judges of the Tax Court in respect to annuities to surviving family members of Tax Court judges. As now worded, section 7448 refers only to a widow (defined as a surviving wife) of a Tax Court judge, and similarly to a mother of issue of a judge's marriage. However, it appears that there is no continuing intent to deny equal protection to the surviving spouses of all Tax Court judges regardless of sex.

The bill eliminates any distinction based on sex and replaces the terms "widow", "widower", "surviving wife", "mother", "her", and "she" with the terms "surviving spouse", "parent", and "such spouse" as appropriate.

Sec. 1906(a)(47) (amends sec. 7471 of the Code)—employees of Tax Court

These amendments delete unnecessary Statutes at Large citations from subsections (a) and (b) of section 7471.

Sec. 1906(a)(48) (amends sec. 7476 of the Code)—declaratory judgments

This amendment makes a clerical correction in placing the material in subsection (a) that follows paragraph (2)(B) at the flush left margin. This is done to make it clear that that material refers to all of subsection (a), and not merely to subsection (a)(2).

Chapter 77. Miscellaneous Provisions

Sec. 1906(a)(49) (amends sec. 7502 of the Code)—timely mailing treated as timely filing

This paragraph is a clerical amendment changing a reference (relating to postmarks) from the "United States Post Office" to the "United States Postal Service" to reflect the enactment of the Postal Reorganization Act.

Sec. 1906(a)(50) (amends sec. 7507 of the Code)—exemption for insolvent banks

These amendments strike out an obsolete date (May 28, 1938) relating to assessment of certain taxes owed by insolvent banks.

Sec. 1906(a)(51) (amends sec. 7508 of the Code)—time for performing certain acts postponed by reason of war

These are clerical amendments changing the heading of section 7508 to refer to "service in a combat zone" and using the defined term "United States" (sec. 7701(a)(9) of the Code) to replace "States of the Union and the District of Columbia".

Sec. 1906(a)(52) (amends sec. 7509 of the Code)—expenditures by the Post Office Department

Subparagraphs (A), (B), and (C) are clerical amendments to use the term "United States Postal Service" in lieu of "United States Post Office" to reflect the enactment of the Postal Reorganization Act.

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Subparagraph (D) eliminates a cross reference to a previously repealed subsection.

Chapter 78. Discovery of Liability and Enforcement of Title

Sec. 1906(a)(53) (amends sec. 7621 of the Code)—internal revenue districts

This amendment eliminates the term "Territory" since there are no longer any Territories.

Sec. 1906(a)(54) (repeals sec. 7641 of the Code)—supervision of operations of certain manufacturers

This provision repeals subchapter C of chapter 78, which contains administrative provisions relating to the taxes on filled cheese, oleomargarine, process or renovated butter, and white phosphorus matches. The tax on these items are repealed by other provisions of the Act or have been repealed by prior law.

Sec. 1906(a)(55) (amends sec. 7652 of the Code)—shipments to the United States

These subparagraphs strike out obsolete provisions relating to payments to the Virgin Islands of taxes collected in 1955 and 1956.

Sec. 1906 (a)(56) (amends sec. 7653 of the Code)—shipments from the United States

This amendment deletes a citation to the Statutes at Large.

Chapter 79. Definitions

Sec. 1906(a)(57) (amends sec. 7701 of the Code)—definitions

Subparagraph (A) defines the term "Secretary" to mean the Secretary of the Treasury or his delegate. (The term "Secretary" is currently defined as the "Secretary of the Treasury".) Subparagraph (A) also provides that the term "Secretary of the Treasury" means the Secretary of the Treasury, personally, not including any delegate.

Subparagraph (B) redefines the term "or his delegate" for purposes of the Internal Revenue Code. This term may include, for example, the Commissioner of Internal Revenue.

To make use of these new terms, subparagraph (A) of subsection (b)(13) of section 1906 of this title amends the Internal Revenue Code by striking out "Secretary or his delegate" each place it appears and inserting in lieu thereof "Secretary". Paragraphs (B), (C), and (M) of subsection (b)(13) strike out "Secretary" and insert in lieu thereof "Secretary of the Treasury" in 19 provisions of the Code which currently use the term "Secretary" without reference to any of his delegates.

Subparagraphs (D), (I), (J), (K), and (L) of subsection (b)(13) change certain derivations of the term "Secretary or his delegate" (such as "Secretary nor his delegate") to "Secretary".

Subparagraphs (E), (F), and (H) of subsection (b)(13) change the term "Secretary" to "Secretary of Labor" in the following sections of the Code: 3304(c), 3310(d)(2), and 3310(e).

Subparagraph (G) of subsection (b)(13) amends sections 3221(a) and 3221(c) of the Code by striking out the words "of the Treasury" following the word "Secretary" so that the notification of certain actions by employers or by the Railroad Retirement Board required by such sections does not have to be made to the Secretary of the Treasury personally.

Chapter 80. General Rules

Sec. 1906(a)(58) (amends sec. 7803 of the Code)—other personnel

This paragraph is a clerical amendment redesignating subsection (d) as subsection (c), the previous subsection (c) having been repealed.

Sec. 1906(a)(59) (amends sec. 7809 of the Code)—deposit of collections

This amendment deletes cross references to provisions repealed by the Comprehensive Drug Abuse Prevention and Control Act of 1970.

Sec. 1906(b)—conforming and clerical amendments

This subsection of the bill makes clerical and conforming amendments to several sections and tables of sections of the Code to reflect the repeal of Code sections 6105, 6162, 6304, 6417, and 7641 and the amendment of Code sections 6111, 6154, 6416, 6420, 6424, 7448, 7508, 7509, and 7701 by section 1906(a) of this title.

Sec. 1906(c)—amendments to sections referring to Territories

This subsection amends sections 6871(a), 7622(b), and 7701(a)(4) of the Code by striking out references to Territories since there are no longer any United States Territories.

Sec. 1906(d)—effective date

Section 1906(d) provides that, except as otherwise expressly provided, the amendments made by section 1906 are to take effect on the first day of the first month which begins more than 90 days after the date of enactment of the bill (October 4, 1976), except that any amendment, when relating to a tax imposed by chapter 1 or chapter 2 of the Code, is to apply with respect to taxable years beginning after December 31, 1976.

SEC. 1907. AMENDMENTS OF SUBTITLE G; THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

Paragraph (1) of subsection (a) substitutes the name "Joint Committee on Taxation" for "Joint Committee on Internal Revenue Taxation" in section 8001. This change is made in the interest of brevity and does not change the functions of the Joint Committee. The duties of the Joint Committee are set forth in section 8022 of the Internal Revenue Code and relate only to internal revenue taxes and to the Internal Revenue Service (or any other agency to the extent it is charged with administration of those taxes).

Paragraph (2) amends section 8004 to refer to the compensation of "the Chief of Staff" instead of "a clerk," thus conforming this provision to the present language of section 8023(b).

Paragraph (3) of subsection (a) strikes out an outdated limitation on the cost of stenographic services incurred by the Joint Committee.

Paragraph (4) is a clerical amendment to make more readable section 8023(c), dealing with the inapplicability of reorganization plans to the Joint Committee.

Paragraph (5) is a general provision that all references in any other statute, or in any rule, regulation, or order, to the Joint Committee on Internal Revenue Taxation are to be considered to be made to the Joint Committee on Taxation.

Subsection (b) also makes conforming amendments to the heading of subtitle G and to the table of subtitles. Subsection (c) provides that the amendments made by this section of the bill are to take effect on the first day of the first month which begins more than 90 days after enactment.

SEC. 1908. EFFECTIVE DATE OF CERTAIN DEFINITIONS AND DESIGNATIONS

This section resolves possible conflicts between amendments made by other titles of the Act and amendments made by these Deadwood provisions. The section states that if another title of the Act contains a term which is defined or modified by the Deadwood provisions, and if that other amendment has an effective date earlier than the effective date of the Deadwood amendment, then the effective date of the Deadwood amendment is converted into the earlier effective date of the amendment made by the other title. This section assures that any term given a particular meaning by the Deadwood provisions has that particular meaning as soon as the Code amendment embodying it becomes effective.

SUBTITLE B—AMENDMENTS OF CODE PROVISIONS WITH LIMITED CURRENT APPLICATION; REPEALS AND SAVINGS PROVISIONS

Sec. 1951. Provisions of subtitle B

Sec. 1951(a) (explanation of references to sections)

This subsection eliminates the need of repeated references to the Internal Revenue Code of 1954 in this section by providing that when this section of the bill refers to an amendment or repeal of a section or other provision, it is to be considered an amendment or repeal of a section or other provision of the Internal Revenue Code.

Sec. 1951(b)(1) (amends sec. 72 of the Code)—certain joint and survivor annuities

Subparagraph (A) of this paragraph removes from the Code a special provision for joint and survivor annuities where the first annuitant died in 1951, 1952, or 1953. Subparagraph (B), however, provides that the deleted provision is to continue to apply in cases of annuity contracts under which distributions were made in taxable years beginning before January 1, 1977, and to which the deleted provision was applicable.

Sec. 1951(b)(2) (amends sec. 108 of the Code)—railroad corporations' discharge of indebtedness

This provision strikes out a special rule of very limited current applicability relating to an exclusion from the income of railroad corporations for income arising from the discharge, cancellation, or modification of indebtedness pursuant to a receivership proceeding or reorganization proceeding under section 77 of the Bankruptcy Act which was commenced before January 1, 1960. The special rule continues to apply, however, to any existing railroad corporation receivership or reorganization proceeding commenced before 1960.

Sec. 1951(b)(3) (amends sec. 164 of the Code)—payments for municipal-type services in Atomic Energy Communities

This paragraph strikes out a provision that authorizes deduction of certain amounts paid to the Atomic Energy Commission (or its successors, currently the Nuclear Regulatory Commission) for municipal-type services in atomic energy communities. However, the committee understands that payments are still being made for such services in Los Alamos, New Mexico. For this reason, the provision is to have continued application to amounts paid or accrued in a community in which the Commission's successor provided municipal-type services on December 31, 1976.

Sec. 1951(b)(4) (repeals sec. 168 of the Code)—60-month amortization of emergency facilities

This paragraph repeals the provision allowing five-year amortization of emergency facilities. The provision is largely obsolete since certification of an emergency facility is required if the rapid amortization is to be allowed, but the existing provision does not permit certification after 1959.

Some additional language in the bill's provision is necessitated by a conforming amendment to section 642(f) of the Code.

Sec. 1951(b)(5) (amends sec. 171 of the Code)—amortizable bond premium for certain bonds acquired after January 22, 1954, and before January 1, 1958

This provision strikes from the Code a special rule relating to the amortizable bond premium of taxable bonds (for which an election is made under section 171(c) of the Code) issued after January 22, 1951, with a call date not more than three years after the issue date, if acquired by the taxpayer after January 22, 1954, and before January 1, 1958.

Although stricken from the Code, this special rule is retained in the public laws for all such bonds.

Sec. 1951(b)(6) (amends sec. 333 of the Code)—liquidations of certain corporations affected by the Revenue Act of 1964

This paragraph deletes a provision allowing stockholders to elect the application of certain nonrecognition of gain rules in cases of liquidation distributions of corporations that were not personal holding companies in one of the two taxable years ending before February 26, 1964 (the date of enactment of the Revenue Act of 1964) but which would in that year have been personal holding companies under the new, stricter provisions of this Act.

Shareholders of such corporations may still claim the benefit of nonrecognition of gain rules applicable to liquidations after 1966 if their corporations meet certain tests and requirements set out in the existing section 333(g) (2). Therefore, the bill retains those particular provisions in the public laws, although they are deleted from the Code.

Sec. 1951(b)(7) (amends sec. 453 of the Code)—certain installment sales prior to 1954

This paragraph strikes from the Code references to the tax treatment of payments on installment sales of realty and casual installment sales of personality concluded before 1954. The special rule applicable to those sales made before 1954 is retained in the public laws, however, for the continued use of taxpayers now eligible to use this rule because their sales were covered by section 44(b) of the Internal Revenue Code of 1939. (Before 1954, installment sales tax treatment for sales of this class could be obtained only if there was a payment or payments of a total not exceeding 30 percent of the selling price in the taxable year of the sale. After 1953, it was not required that there be any payment in the year of sale.)

Sec. 1951(b)(8) (amends sec. 512 of the Code)—exclusions from unrelated business taxable income

This paragraph deletes a provision of the Code (sec. 512(b)(13)) excluding from the definition of unrelated business taxable income certain income received by exempt trusts created by the wills of individuals who died between August 16, 1954, and January 1, 1957, if that income is received by those trusts as limited partners (as defined). Also deleted is an exclusion of income used by a labor, agricultural, or horticultural organization to establish, maintain, or operate a retirement home, hospital, or similar facility, if the income is derived from agricultural pursuits on grounds contiguous to the facility and if the income does not provide more than 75 percent of the cost of operating or maintaining the facility.

For both cases, a savings provision is retained in the public laws to continue to allow these exclusions.

Sec. 1951(b)(9) (amends sec. 545 of the Code)—deductions allowable in computing personal holding company income

This provision strikes from the Code a paragraph (sec. 545(b)(9)) which permits the deduction from personal holding company income (upon which a special 70-percent tax rate is imposed) of the amount of any properly filed lien in favor of the United States to which the taxpayer is subject at the end of the taxable year. This provision appears to have rare, if any, usage now. It was enacted in 1951 for the benefit of a personal holding company which is no longer in existence.

The paragraph to be deleted also requires the sum of the amounts deducted to be recaptured by their inclusion in the taxable income of the taxpayer for the year the lien is satisfied or released, and it permits the taxpayer's shareholders to compute the income tax on dividends attributable to amounts so included in income as though they were received ratably over the period the lien was in effect. These latter provisions are retained in the public laws for application to recaptures, on account of liens satisfied or released in taxable years beginning on or after January 1, 1977, of deductions taken in taxable years beginning before that date.

Sec. 1951(b)(10) (amends sec. 691 of the Code)—installment obligations received from a decedent

This paragraph deletes the provision allowing taxpayers to elect to report, on a pro rata basis, installment payments on certain obligations transferred from a decedent (in taxable years to which the 1939 Code applied) without the necessity of maintaining a bond with the Internal Revenue Service to guarantee the proper reporting of the installment payments, as had been necessary with respect to returns required to be filed before September 3, 1964.

It is believed either that none of these obligations are still outstanding, or, if any are, that the taxpayers have already exercised the election. This amendment preserves the rights of any taxpayers still reporting such installment payments who will have made the election with respect to taxable years beginning before January 1, 1977.

Sec. 1951(b)(11) (amends sec. 817 of the Code)—life insurance company gains on transactions occurring prior to January 1, 1959

This paragraph deletes from the Code section 817(d), which excludes from taxation gains realized by life insurance companies in cases of gains from, or considered under the life insurance company tax provisions as from, the sale or other disposition of a capital asset (or of property which, except for section 817(d), would constitute section 1231 assets) before 1959. Before 1959, such gains were usually not subject to tax in the case of life insurance companies.

It is unlikely that this provision has any current applicability since taxpayers are not likely to be currently receiving gains from pre-1959 dispositions, except in the limited area of installment sales. In those cases, the number of transactions to which the provision might apply may be expected to decrease each year. For these reasons, the provision is removed from the Code, but retained in the public laws.

Sec. 1951(b)(12) (repeals sec. 1347 of the Code)—claims filed against the United States before January 1, 1958

This paragraph deletes from the Code a provision limiting to 33 percent of the amount paid (without taking into account the interest paid), the tax payable on payments by the United States on claims unpaid for 15 years and involving the acquisition of property. The provision applied only if the claim was filed before January 1, 1958.

It is believed that no claim of the type described in section 1347 is still outstanding. If any does exist, however, it will remain subject to the same tax treatment by virtue of the inclusion in the public laws of the provision deleted from the Code.

Several conforming changes necessitated by the deletion of section 1347 are also made.

Sec. 1951(b)(13) (repeals sec. 1471 of the Code)—recovery of excessive profits on Government contracts subject to the Vinson-Trammell Act

This paragraph deletes from the Code a provision relating to a few possible situations of excessive profits on Government contracts not covered by the Renegotiation Act. In addition, the provision would be fully operative if the Renegotiation Act should ever be allowed to expire. Since this provision does not involve taxation as such, but instead provides for collection of certain excessive profits as taxes are collected, it is removed from the Code but retained in the public laws.

Sec. 1951(b)(14) (amends sec. 1481 of the Code)—renegotiated excessive defense contract profits of taxable years governed by the Internal Revenue Code of 1939

This paragraph deletes from the Code a provision (section 1481(d)) regarding the readjustment of taxes for taxable years governed by the Internal Revenue Code of 1939 if excessive defense contract profits taxed in those years are recaptured by the Government pursuant to the Renegotiation Act of 1951, as amended.

It is believed that no years governed by the Internal Revenue Code of 1939 (in general, taxable years beginning before January 1, 1954) are now in court or in the renegotiation process. However, it appears that some excessive profits renegotiated for years subject to the 1939 Code are still being collected. In addition, defense contractors and subcontractors who failed to file reports of renegotiable profits for those years could be required to file such reports (although this is considered an unlikely possibility). For these reasons, the provision deleted from the Code is retained in the public laws.

Sec. 1951(c)—conforming and clerical amendments

This subsection provides conforming and clerical amendments necessitated by the repeals made by section 1951(b) of this title.

Sec. 1951(d)—effective date

Subsection (d) provides that the amendments made by section 1951 (b) and (c) of this title, except as otherwise expressly provided, are to apply to taxable years beginning after December 31, 1976.

SEC. 1952. PROVISIONS OF SUBCHAPTER D OF CHAPTER 39; COTTON FUTURES

This section repeals provisions (sections 4851 through 4877 of the Code) taxing cotton futures contracts. These provisions impose prohibitory taxes upon cotton futures contracts which do not meet the requirements set forth in these provisions and in related Department of Agriculture regulations. No tax is collected under these provisions, which provide the necessary authority to regulate the cotton futures market. (See legislative findings in title 7 of the United States Code at section 5, 6a (first sentence), and 2101 (second and third sentences).) The bill reenacts these provisions (providing appropriate penalties), which results in transferring the law on this subject out of the Internal Revenue Code. The material in this section has been reviewed by the Department of Agriculture, the New York Cotton Exchange, and the staff of the Committee on Agriculture of the House of Representatives.

A number of conforming and clerical amendments to the Code are necessitated by the repeal of sections 4851 through 4877 and are made by subsection (n). The provisions of this section of the title are to take effect on the 90th day after the date of enactment.

S. ESTATE AND GIFT TAXES

1. Unified Rate Schedule for Estate and Gift Taxes; Unified Credit in Lieu of Specific Exemptions (sec. 2001 of the Act and secs. 2001, 2010, 2011, 2012, 2013, 2014, 2035, 2038, 2052, 2101, 2102, 2104, 2106, 2206, 2207, 2502, 2504, 2505, 2521, and 6018 of the Code)

a. Unified Rate Schedule

Prior law

An estate tax is imposed on transfers at death and a gift tax is imposed on transfers during life. Under prior law, each tax had a separate rate schedule and exemption.

The rates under the prior gift tax rate schedule were progressive and ranged from 2¼ percent on the first $5,000 in taxable gifts by a donor to 57¾ percent on taxable gifts by a donor (computed on a cumulative basis) in excess of $10 million. The gift tax rates were three-fourths of the estate tax rates for the corresponding brackets. The tax was based on the fair market value of the gifts made by a donor reduced by amounts allowable under the $3,000 per donee annual exclusion, allowable charitable and marital deductions, and, under prior law, any portion of the gift tax specific exemption of $30,000 which had not been used for previous gifts by the donor. The gift tax base was the value of the property transferred to a donee, and did not take into account the gift taxes paid by the donor with respect to the transfer.

The estate tax rates also are progressive and, under prior law, ranged from 3 percent of the first $5,000 of the taxable estate to 77 percent of the taxable estate in excess of $10 million.[1]

The tax base, or taxable estate, is determined by deducting from the value of the gross estate the allowable deductions for estate administration and funeral expenses, claims against the estate, casualty and theft losses sustained during administration of the estate, the charitable and marital deductions, and, under prior law, the estate tax specific exemption of $60,000. Generally, the estate tax base was determined solely by reference to transfers at death without regard to the amount of lifetime transfers or the gift taxes paid on those transfers. The estate tax was based on the value of the estate without diminution for the amount which was used to pay the Federal estate tax (unlike the gift tax provisions under which the tax base is the value of the property transferred to a donee).

In certain cases, lifetime transfers which were made by a decedent are also included in the gross estate. A lifetime transfer is included in

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[1] In the case of nonresident aliens, the estate tax imposed on the portion of the estate situated in the United States ranged from 5 percent of the first $100,000 of the taxable estate to 25 percent of the taxable estate in excess of $2 million.

a decedent's gross estate if he had retained certain interests, rights, or powers in the property transferred. In addition, transfers made "in contemplation of death" were included in the decedent's gross estate (to minimize the incentive to transfer property in anticipation of death because of the favorable gift tax treatment). Transfers made within 3 years of death were presumed to be made "in contemplation of death" and included in the decedent's gross estate unless the executor could prove to the contrary. If a lifetime transfer was included in the decedent's gross estate, credit against the estate tax was allowed for the gift tax paid on the transfer (although the amount of gift tax paid itself was excluded from the gross estate).

Reasons for change

Under prior law, there was a substantial disparity of treatment between the taxation of transfers during life and transfers at death. In general, there were three factors which provided a decided preference for lifetime transfers. First, the gift tax rates were set at three-fourths of the estate tax rates at each corresponding rate bracket. Second, lifetime transfers were not taken into account for estate tax purposes and the estate remaining at death was subject to tax under a separate rate schedule starting at the lowest rates. Thus, even if the rates were identical, separate rate schedules provided a preference for making both lifetime and deathtime transfers rather than having the total transfer subject to one tax. Third, the gift taxes paid were not generally taken into account for either transfer tax base. In the case of a gift, the tax base did not include the gift tax but the payment of the tax resulted in a decrease in the value of the estate retained by the donor. However, if the property were retained until death, the tax base included the full value of the property, even though a portion might be required to satisfy estate taxes. Thus, even if the applicable transfer tax rates were the same, the net amount transferred to a beneficiary from a given pre-tax amount of property was greater for a lifetime transfer solely because of the difference in the tax bases.

As a matter of equity, the Congress believed the tax burden imposed on transfers of the same amount of wealth should be substantially the same whether the transfers are made both during life and at death or made only upon death. As a practical matter, the preferences for lifetime transfers are available only for wealthier individuals who are able to afford lifetime transfers. The preference for lifetime transfers are not generally available for those of small and moderate wealth since they generally want to retain their property until death to assure financial security during lifetime. Therefore, the Congress believed that the preferences for lifetime transfers principally benefit the wealthy and resulted in eroding the transfer tax base.

The Congress believed that it was desirable to reduce the disparity of treatment between lifetime and deathtime transfers through the adoption of a single unified estate and gift tax rate schedule providing progressive rates based on cumulative lifetime and deathtime transfers. However, the Congress retained part of the incentives for lifetime transfers. Thus, the provisions of prior law under which the amount of gift tax was not included or "grossed up" in the transfer tax base are continued, except in the case of gifts made within three years of the date of death. In addition, the annual gift tax exclusion of $3,000 per donee is continued. The advantage of avoiding a transfer tax on the appreciation which might accrue between the time of a gift and the donor's death represents a further incentive for lifetime transfers.

The estate tax provisions relating to transfers in contemplation of death have caused substantial problems for executors, beneficiaries, and the Internal Revenue Service. The presumption under prior law that gifts made within 3 years of death were in contemplation of death has caused considerable litigation concerning the motives of decedents in making gifts. The Congress believed that this problem should be eliminated by requiring the inclusion of all such gifts in the gross estate without having to attempt to ascertain the motives of the decedent. Under a unified transfer tax system, this requirement does not affect the tax imposed upon most estates in a major way because the gift taxes paid are allowed as a credit in determining the net estate tax due.

Since the gift tax paid on a lifetime transfer which was included in a decedent's gross estate was taken into account both as a credit against the estate tax and also as a reduction in the estate tax base, substantial tax savings could be derived under prior law by making so-called "deathbed gifts" even though the transfer was subject to both taxes. To eliminate this tax avoidance technique, the Congress believed that the gift tax paid on transfers made within 3 years of death should in all cases be included in the decedent's gross estate. This "gross-up" rule will eliminate any incentive to make deathbed transfers to remove an amount equal to the gift taxes from the transfer tax base.

Explanation of provisions

The Act provides a single unified rate schedule for estate and gift taxes. The rates are progressive on the basis of cumulative lifetime and deathtime transfers. The unified rate schedule eliminates the preferential rates for lifetime transfers (which were three-fourths of the estate tax rates at each corresponding bracket). In general, the rules established under prior law are retained as to when a gift is considered to be completed for gift tax purposes and as to when property is included in a decedent's gross estate for estate tax purposes. However, the estate tax rules concerning transfers in contemplation of death are modified as described below.

Under the unified rate schedule, the rates are to range from 18 percent for the first $10,000 in taxable transfers to 70 percent of taxable transfers in excess of $5 million. However, after taking into account the unified credit in lieu of an exemption, the lowest rate at which tax liability is actually incurred under the schedule would be in a higher marginal tax bracket. For 1977, 1978, and 1979, the lower marginal rate at which liability is first incurred is to be 30 percent, after taking into account the unified credit after 1979, the lowest marginal rate at which liability is first incurred is to be 32 percent, after taking into account the unified credit.

The amount of gift tax payable (for any calendar quarter or year, as the case may be) is to be determined by applying the unified rate schedule to the cumulative lifetime taxable transfers and then subtracting the taxes payable on the lifetime transfers made for past taxable periods. In computing cumulative taxable gifts for preceding taxable periods, the donor's taxable gifts for periods preceding January 1, 1977, are to be taken into account. At the same time, in computing the tax payable, the reduction for taxes previously paid is to be based upon the new unified rate schedule even though the gift tax actually imposed upon prior transfers may have been less than this amount. Thus, a donor's previous taxable gifts only affect the starting point in determining the applicable rate and net tax on gifts made after December 31, 1976.

The amount of estate tax is to be determined by applying the unified rate schedule to the aggregate of cumulative lifetime and deathtime transfers and then subtracting (or "offsetting") the gift taxes payable on the lifetime transfers (i.e., the gift tax payable after application of the unified credit allowable with respect to the lifetime transfers). As a transitional rule, the completed lifetime transfers taken into account in determining cumulative transfers at death for purposes of imposing the estate tax are only to include taxable gifts made after December 31, 1976. Correspondingly, the gift tax paid with respect to gifts made before January 1, 1977, is not to be included as part of the subtraction or offset in computing the estate tax. The subtraction, or offset, is to include the aggregate amount of gift tax payable on gifts made after December 31, 1976.

Transfers included in the tax base as lifetime transfers (described as "adjusted taxable gifts" by the Act) are not to include transfers which are also included in the decedent's gross estate (i.e., transfers made within three years of the date of death and lifetime transfers where the decedent had retained certain interests, rights, or powers in the property). This is to preclude having the same lifetime transfers taken into account more than once for transfer tax purposes. However, the gift tax payable on these transfers is to be subtracted in determining the estate tax imposed.

In addition, the gift tax paid by a spouse is to be a subtraction, or offset, in computing the estate tax imposed where the transfer subject to the tax is included in the decedent's gross estate and was considered to have been a transfer made in part by the surviving spouse under the gift-splitting provisions of the tax law. The effect of this treatment is to reverse the consequences of having treated the surviving spouse as the donor of one-half of a gift made to a third party for gift tax purposes where the property transferred is subsequently included in the decedent's gross estate. However, there is to be no restoration of any portion of the unified credit used against gift taxes paid by the surviving spouse. (This treatment is similar to court decisions reached under prior law which did not permit restoration of any portion of the gift tax exemption used with respect to a transfer which was later included in the other spouse's estate because it was made in contemplation of death.)

The Act provides for the inclusion in the decedent's gross estate of all gifts made during the 3-year period ending on the date of the decedent's death. Thus, the presumption of prior law that a gift made within that period is made in contemplation of death is eliminated. The presumption of prior law was intended to prevent the avoidance of estate taxes by making lifetime transfers in anticipation of death. The presumption was provided because the Supreme Court, in *Heiner* v. *Donnan*,[2] held that a conclusive pre-

[2] 285 U.S. 312 (1932).

sumption created an unreasonable classification in violation of the due process clause of the Fifth Amendment because it resulted in taxing some *inter viros* transfers under the estate tax because of the fortuitous event of death while other similar transfers were exempt. Even assuming that the 1932 case would be followed today, the Congress believed that the approach taken under the Act is distinguishable from the statute which was held to be unconstitutional. First the Act does not provide a presumption as to whether a transfer is in contemplation of death. The theory underlying the provision does not depend on whether the transfer was in contemplation of death as a substitute for a testamentary disposition. The donor's motive is immaterial. Second, the 1932 decision dealt with the impact of the contemplation of death rules under a taxing statute where substantial differences in tax liability would have risen, depending upon whether or not a lifetime transfer was included in a decedent's gross estate because no gift tax was imposed at that time.

With the adoption of a single unified rate schedule, the tax impact of a rule requiring the inclusion of all transfers made within 3 years of death is not as significant as would be the case where either no separate gift tax is imposed or a dual tax system providing rate differentials between lifetime and deathtime transfers is imposed. The most significant adverse consequence would result where the property transferred substantially appreciates in value between the date of the transfer and the date of the decedent's death. On the other hand, the inclusion of these transfers may enlarge the amount deductible as a marital deduction, since it would be taken into account as part of the adjusted gross estate to which the 50-percent limitation applies.

Under the rule for transfers made within 3 years of death, an exception is provided for transfers for an adequate and full consideration in money or money's worth. Generally the inclusion rule will only apply to transfers treated as gifts for gift tax purposes. In addition, another exception is provided on the basis of administrative convenience so that the amount of gifts included is limited to the excess of the estate tax value over the amount excludible with respect to the gifts under the $3,000 annual gift tax exclusion.

In determining the amount of the gross estate, the amount of gift tax paid within 3 years of death is to be includable in a decedent's gross estate. This "gross-up" rule for gift taxes eliminates any incentive to make deathbed transfers to remove an amount equal to the gift taxes from the transfer tax base. The amount of gift tax subject to this rule would include tax paid by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976. It would not, however, include any gift tax paid by the spouse on a gift made by the decedent within 3 years of death which is treated as made one-half by the spouse, since the spouse's payment of such tax would not reduce the decedent's estate at the time of death.

The Act also provides for the unification of estate and gift taxes in the case of estates of nonresident aliens who owned or transferred property situated in the United States. As under prior law, the gift tax provisions applicable to citizens and residents are also to apply to gifts of property situated in the United States by a nonresident alien. Also, a special estate tax rate schedule is to apply to the estate of nonresident aliens, as under prior law. The rate schedule is revised to provide rates ranging from 6 percent on the first $100,000 in taxable transfers to 30 percent on taxable transfers over $2 million. As in the case of the regular estate tax, the amount of estate tax would be determined by applying the unified rate schedule to the cumulative lifetime and deathtime transfers subject to United States transfer taxes and then subtracting the gift taxes payable on the lifetime transfers. The lifetime transfers to be taken into account in computing the estate tax would include gifts made by the decedent after December 31, 1976.

The special credit against estate tax for gift tax payable with respect to lifetime transfers which are included in a decedent's gross estate (sec. 2012) is not to apply to gifts made after December 31, 1976. For these gifts, the computation of the gross estate tax payable will reflect the credit for gift tax paid on lifetime transfers included in the gross estate. Thus, the special gift tax credit provision is not necessary under a unified transfer tax approach.

Effective date

In general, the amendments apply to the estates of decedents dying after December 31, 1976, and to gifts made after December 31, 1976. However, the amendments relating to the estate tax treatment of transfers made within three years of a decedent's death do not apply to transfers made before January 1, 1977. The contemplation of death rules under prior law will apply to gifts made before January 1, 1977, where the decedent dies after December 31, 1976, and the transfer is made within 3 years of death.

b. Unified Credit in Lieu of Specific Exemptions

Prior law

Under prior law, separate exemptions were provided for estate and gift taxes. The gift tax specific exemption was $30,000 for each donor. In the case of a married couple, the exemption available was, in effect $60,000 if the spouse consented to treat one-half of the gifts made by the donor spouse as being made by him or her. The specific exemption was in addition to the annual $3,000 per donee exclusion.

Under prior law, the estate tax specific exemption was $60,000. In the case of a nonresident alien, the exemption was $30,000. The estate tax exemption was not increased for any portion of the gift tax specific exemption which was not used against lifetime transfers.

Reasons for change

The amount of the estate tax exemption was established in 1942. Since that date, the purchasing power of the dollar has decreased to less than one-third of its value in 1942. To some extent this effect has been mitigated by the addition of a provision for a marital deduction in 1948. Despite this change in 1948, the inflation which has occurred means that the estate tax now has a much broader impact than it did originally.

In addition, since the estate tax exemption under prior law was a deduction in determining the taxable estate, it reduced each estate's tax at the highest estate tax brackets. However, a credit in lieu of an exemption has the effect of reducing the estate tax at the lower estate tax brackets since a tax credit is applied as a dollar-for-dollar reduction of the amount otherwise due. Thus, at a given level of revenue cost, a tax credit tends to confer more tax savings on small- and medium-sized estates, whereas a deduction or exemption tends to confer more tax savings on larger estates. The Congress believed it would be more equitable if the exemption were replaced with a credit.

As a practical matter, the gift tax exemption was not available to individuals who could not afford to make lifetime transfers. Thus, the overall transfer tax exemption was effectively greater for individuals who were financially able to utilize the gift tax exemption through lifetime transfers. The Congress believed that it would be more equitable if a unified credit in lieu of an exemption were available on an equal basis without regard to whether the transfers were made only at death or were made both during lifetime and at death.

Explanation of provisions

The Act provides a unified credit against estate and gift taxes, in lieu of the specific exemptions provided under prior law. The credit is to be phased-in over a 5-year period. Subject to a transitional rule for certain gifts, the amount of the credit is $30,000 for gifts made in, and decedents dying in, 1977, $34,000 in 1978, $38,000 in 1979, $42,500 in 1980, and $47,000 in 1981.

The unified credit allowable is to be reduced by an amount equal to 20 percent of the amount allowed as a specific exemption under prior law for gifts made after September 8, 1976, and before January 1, 1977. However, the unified credit is not to be reduced for any amount allowed as a specific exemption for gifts made prior to September 9, 1976. As a transitional rule for gift tax purposes, only $6,000 of the unified credit can be applied with respect to gifts made after December 31, 1976, and prior to July 1, 1977.

In general, any portion of the unified credit used against gift taxes will reduce the credit available to be used against the estate tax. The unified credit rules are set forth separately under the estate and gift tax provisions of the Act. Since the credit used against gift taxes is reflected as a reduction in gift taxes payable, for purposes of determining the estate tax payable, a corresponding estate tax provision is set forth separately to preserve the effect of the credit. However, because of the interrelationship of the separate credit and the computation of the estate tax payable, the separate estate tax credit provision does not operate to permit the allowance of the credit both as to lifetime transfers and also as to deathtime transfers. Thus, the credit is in effect a single unified credit for estate and gift tax purposes. In addition, the application of the unified credit is mandatory with respect to transfers in the order of time in which they are made.

The amount of the unified credit to be allowed is not to exceed the amount of transfer tax imposed.

Since the limitation on the credit against the estate tax for State death taxes is determined by reference to the taxable estate, a conforming change is made to reflect the fact that the credit does not enter into the computation of the taxable estate. The purpose of the conforming change is to continue the allowance of the same amount for the State death tax credit as under prior law.

The estate tax filing requirement is revised by the Act to conform to the adoption of a higher credit in terms of exemption equivalent. To reflect the exemption equivalent after it is fully phased-in, an estate tax return is to be required if the decedent's gross estate exceeds $175,000, rather than $60,000 as provided by prior law. During the phase-in period for the unified credit, the filing requirements are to be $120,000, $134,000, $147,000, and $161,000 for estates of decedents dying in 1977, 1978, 1979, and 1980, respectively. However, the applicable amount would be adjusted for certain lifetime transfers. The applicable amounts would be reduced by the sum of the adjusted taxable gifts made by the decedent after December 31, 1976, and the amount of the specific gift tax exemption under prior law which may have been used by the decedent with respect to gifts made after September 8, 1976, and before 1977.

In the case of the estate of a nonresident alien a credit of $3,600 is to be allowed against the estate tax. No credit against gift tax is to be allowable. This is similar to the provision under prior law which did not make the specific gift tax exemption available to a nonresident alien unless it was provided under an applicable tax treaty.

In the case of a resident of a possession of the United States, the credit allowable is to be the greater of $3,600 or the proportion of $15,075 which the value of the property situated in the United States bears to the value of the entire gross estate wherever situated. For estates of decedents dying during 1977, 1978, 1979, and 1980, the $15,075 amount is to be $8,480, $10,080, $11,680, and $13,388, respectively.

In the case of the estate tax provisions relating to expatriation to avoid estate tax, the credit allowable is to be $13,000.

Effective date

These amendments are to apply to estates of decedents dying after December 31, 1976, and to gifts made after December 31, 1976.

2. Increase in Limitations on Marital Deductions; Fractional Interest of Spouse (Sec. 2002 of the Act and Secs. 2056, 2523 and 2040 of the Code)

a. Increase in Marital Deductions

Prior law

Under estate tax law, an estate of a decedent is allowed a deduction for estate tax purposes for certain property passing from the decedent to the surviving spouse. Under prior law, the maximum allowable deduction was 50 percent of the adjusted gross estate of the decedent. In addition, a marital deduction is allowed for gift tax purposes in the case of lifetime transfers to a spouse. In the case of gifts, the maximum allowable deduction was 50 percent of the value of the property transferred to the spouse. The marital deduction generally equates the tax results of transfers between the spouses in common law states and those in community property states.[1] The decedent's share of community property passing to a spouse is not eligible for the marital deduction, because only the decedent's share of the community property is included in the gross estate.

[1] The limitation of 50 percent was an attempt to provide substantial parity between common law States and community property law States. In community property States, generally only 50 percent of the community property is treated as owned by the deceased spouse and included in the gross estate.

Reasons for change

The Congress believed that a decedent with a small- or medium-sized estate should be able to leave a minimum amount of property to the surviving spouse without the imposition of an estate tax. The Congress further believed that the prior limitation on transfers to a spouse free of gift tax was too restrictive and tended to interfere with normal interspousal lifetime transfers.

Explanation of provisions

The Act increases the maximum estate tax marital deduction for property passing from the decedent to the surviving spouse to the greater of $250,000 or one-half of the decedent's adjusted gross estate. The $250,000 amount is adjusted where the decedent owns community property at death, so that the parity provided under prior law between common law property and community property law states is continued.

The Act also amends the gift tax marital deduction to provide an unlimited deduction for transfers between spouses for the first $100,000 in gifts. Allowance of the marital deduction is determined on the basis of the donor's and donee's marital status at the time of the gift and, in the case of the remarriage of the donor, the unlimited marital deduction would be determined on the basis of the aggregate amount of gifts made to all spouses. Thereafter, the deduction allowed will be 50 percent of the interspousal lifetime transfers in excess of $200,000. Under this provision, the limitation on the estate tax marital deduction is to be reduced by the amount of the marital deduction allowed for lifetime transfers in excess of 50 percent of the value of the transfers (i.e., where lifetime gifts eligible for the marital deduction are less than $200,000).

Effective date

In general, these provisions are effective with respect to the estates of decedents dying after December 31, 1976, and to gifts transferred after December 31, 1976.

Because the maximum estate tax marital deduction under prior law was limited to one-half the adjusted gross estate, many existing wills and trusts provide a maximum marital deduction formula clause. The Congress was concerned that many testators, although using the formula clause, may not have wanted to pass more than one-half the estatae (recognizing the prior law limitation) to the spouse. For this reason a two-year transition rule provides that the increased estate tax marital deduction, as provided by the Act, will not apply to transfers resulting from a will executed or trust created before January 1, 1977, which contains a maximum marital deduction clause provided that: (1) the formula clause is not amended before the death of the decedent, and (2) there is not enacted a State law, applicable to the estate, which would construe the formula clause as referring to the increased marital deduction as amended by the Act. This transitional rule will be effective for decedents dying after December 31, 1976 and before January 1, 1979.

b. Fractional Interests of Spouse

Prior law

Under gift and estate tax law, the creation and termination of joint property interests have differing gift and estate tax consequences de-

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pending on the nature of the joint property, the type of joint ownership, the consideration paid by each co-owner for the property, and the ownership rights in the property under local law.

For gift tax purposes, a completed transfer is a prerequisite to the imposition of the tax. If a joint tenant, who has furnished all the consideration for the creation of the joint tenancy, is permitted to draw back to himself the entire joint property (as in a typical joint bank account), the transfer is not complete and there is no gift at that time. If the creation of a joint tenancy has resulted in a completed transfer, the value of the gift will depend upon whether, under applicable local law, the right of survivorship may be defeated by either owner unilaterally. If either joint tenant, acting alone, can bring about a severance of his interest, the value of the gift will be one-half the value of the jointly held property. If the right of survivorship is not destructible except by mutual consent, then the value of the gift requires a calculation which takes into account the ages of the donor and the other concurrent owner. This calculation is necessary because the younger of the tenants, who has a greater probability of surviving and taking all the property, has a more valuable interest.

Although the creation or termination of completed transfers of joint interests in property (whether real or personal) is automatically subject to the gift tax, the gift tax law provides for an election in the case of the creation of a tenancy by the entirety in real property. The creation of such a tenancy by the entirety (or joint tenancy between husband and wife with rights of survivorship) will not be considered a gift unless the donor elects to have the transfer treated as a gift at that time. If the donor does not make the election, a taxable gift is not considered to have been made until the termination of the tenancy (provided the termination occurs otherwise than by death of a spouse).

For estate tax purposes, the tax law provides that on the death of a joint tenant the entire value of the property owned in joint tenancy is included in a decedent's gross estate except for the portion of the property which is attributable to the consideration furnished by the survivor. Thus, if the decedent furnished the entire purchase price of the jointly owned property, the value of the entire property is included in his gross estate. If it can be demonstrated that the survivor furnished part of the purchase price, only a portion of the value of the property is included in the decedent's gross estate.

In the case of certain trade or business activities conducted jointly in the form of a family partnership, the partnership interest held by the surviving spouse will not be included in the deceased spouse's gross estate. The effect of this is that the services performed by the surviving spouse in connection with the family owned business are taken into account, by reason of the profit sharing ratio, as consideration furnished for the purchase of jointly owned property used in the trade or business if a partnership is used to conduct business.[2] This rule applies even though the applicable local law would treat the income and, therefore, the "consideration furnished," with respect to a jointly operated family business which is not conducted under the partnership form of business, as belonging to the husband during the marriage.

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[2] See also, *Estate of Otte,* 31 CCH Tax Ct. Mem. 301 (1972).

Reasons for change

The Congress believed that the prior application of the provisions relating to jointly owned property was unnecessarily complex and may result in the same properties being subject to both the gift and estate taxes. This double taxation (although mitigated by the allowance of a credit for gift taxes paid) occurs because the gift tax consequences of joint ownership flow from legal interests created under local law while the estate tax consequences are determined by the decedent's relative contribution to the purchase price. Further, the Congress recognized that it is often difficult, as between spouses, to determine the degree to which each spouse is responsible for the acquisition and improvement of their jointly owed property.

Explanation of provision

Under the Act, one-half of the value of a qualified joint interest is included in the gross estate of the decedent at the date of the decedent's death (or alternate valuation date), regardless of which joint tenant furnished the consideration. An interest is a qualified joint interest only if the following requirements are satisfied: (1) the interest must have been created by the decedent or his spouse, or both; (2) in the case of personal property, the creation of the joint interest must have been a completed gift for purposes of the gift tax provisions; (3) in the case of real property, the donor must have elected to treat the creation of the joint tenancy as a taxable event at that time (even though no gift tax is actually paid because of the annual exclusion, marital deduction, or use of the unified credit); and (4) the joint tenants cannot be persons other than the decedent and his spouse. Thus, if a donor creates a joint interest in real property with his spouse on January 1, 1977, and makes the election to have the creation of the joint tenancy treated as a taxable gift at that time, then, upon the death of one spouse, only one-half of the value of the property is to be included in the gross estate of the decedent.

The provision is to apply to joint interests created after December 31, 1976. For this purpose, the chain of title of the property before the creation of the joint tenancy is immaterial. Thus, if a severance or partition of an existing joint tenancy is made after December 31, 1976, and the joint tenancy between the spouses in that property is then recreated, the creation of the new joint tenancy will be eligible for the fractional interest rule so long as the other requirements are satisfied and the creation of the new joint tenancy is valid under local law. The tax consequences, if any, of the severance or partition of the existing joint interest will continue to be determined in accordance with the provisions in effect prior to the Act, e.g., no gift will be considered to have been made if the property interests or proceeds are distributed or reinvested in proportion to the consideration furnished by each. The amount of consideration furnished by each spouse for the recreation of the joint tenancy will also continue to be determined under the principles in effect prior to the Act. The election provided under the gift tax provisions for joint interests in real estate will then be available with respect to the amount of the gift determined.

The donor is to make the election by including the transfer in the gift tax return for the calendar quarter in which the joint tenancy was created. The effect of including only one-half the value of the property in the gross estate in these situations is to implicitly recognize the services furnished by a spouse toward the accumulation of the jointly owned property even though a monetary value of the services cannot be accurately determined.

If the donor does not elect (in the case of real property) to treat the transfer as a gift at the time of the creation of the interest (by not including the transfer on a timely filed gift tax return), then, upon the death of a spouse, the joint property is to be subject to inclusion in the gross estate at the full value of the property less the value attributable to any contribution that can be traced to the survivor. If the creation of the joint tenancy is not a completed transfer for gift tax purposes (as, for example, a joint bank account in which either tenant is entitled to withdraw the entire account), the new rules added by the Act will not apply, and upon death of either co-tenant the property will be subject to inclusion in the gross estate at full value, subject to the contribution-furnished test.

Once the election is made with regard to the creation of the joint tenancy in real property, it applies to all subsequent additions in value to that property. Thus, additional gift tax returns will be required to be filed with respect to additions in value for any taxable period in which gifts to the donee spouse exceed the $3,000 annual exclusion. For purposes of this provision, additions in value would include mortgage payments on debts against the property as well as improvements made to the property. For this purpose, the mere appreciation in the value of the property is not to constitute additional gifts. If this election is made the value of real property to be included in the gross estate is one half the value of the property at the date of the decedents' death, even though the joint tenancy, under local law, can be broken only with mutual consent. In addition the actuarial computations normally necessary to determine a gift upon creation of a joint tenancy between spouses are not required in the case of real property.

The Act does not change the treatment of interests of spouses in family partnerships for estate and gift tax purposes.

Effective date

In general, this provision is effective with respect to joint interests created after December 31, 1976.

3. Valuation for Purposes of the Federal Estate Tax of Certain Real Property Devoted to Farming or Closely Held Business Use (sec. 2003 of the Act and secs. 2032A and 6324B of the Code)

Prior law

Under the estate tax law, the value of property included in the gross estate of a decedent is the fair market value of the property interest at the date of the decedent's death (or at the alternate valuation date if elected). The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. One of the most important factors used in determining fair market value is the highest and best use to which the property can be put.

Where the fair market value of real property is the subject of dispute, there are several valuation techniques which the courts tend to accept. These methods include the income-capitalization technique, the reproduction-cost minus depreciation technique, and the comparative sales technique. Courts will generally use one of these methods, or a combination of these methods, in determining fair market value.

However, in all cases, it is presumed that land would change hands between a willing buyer and a willing seller based on the "highest and best use" to which that land could be put, rather than the actual use of the land at the time it is transferred.

Reasons for change

The Congress believed that, when land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential "highest and best use" especially since it is desirable to encourage the continued use of property for farming and other small business purposes. Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes. Also, where the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, the Congress believed it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming or closely held businesses.

However, the Congress recognized that it would be a windfall to the beneficiaries of an estate to allow real property used for farming or closely held business purposes to be valued for estate tax purposes at its farm or business value unless the beneficiaries continue to use the property for farm or business purposes, at least for a reasonable period of time after the decedent's death. Also, the Congress believed that it would be inequitable to discount speculative values if the heirs of the decedent realize these speculative values by selling the property within a short time after the decedent's death.

For these reasons, the Act provides for special use valuation in situations involving real property used in farming or in certain other trades or businesses, but has further provided for recapture of the estate tax benefit where the land is prematurely sold or is converted to nonqualifying uses.

Explanation of provisions

Special valuation in general.—The Act provides that, if certain conditions are met, the executor may elect to value real property included in the decedent's estate which is devoted to farming or closely held business use on the basis of that property's value as a farm or in the closely held business, rather than its fair market value determined on the basis of its highest and best use. However, this special use valuation can not reduce the decedent's gross estate by more than $500,000.

Qualification by estate.—To qualify for this special use valuation: (1) the decedent must have been a citizen or resident of the United States at his death; (2) the value of the farm or closely held business assets in the decedents' estate, including both real and personal property (but reduced by debts attributable to the real and personal property), must be at least 50 percent of the decedent's gross estate (reduced by debts and expenses); (3) at least 25 percent of the adjusted value of the gross estate must be qualified farm or closely held business real property; (4) the real property qualifying for special use valuation must pass to a qualified heir; (5) such real property must have been owned by the decedent or a member of his family and used or held for use as a farm or closely held business for 5 of the last 8 years prior to the decedent's death; and (6) there must have been material participation [1] in the operation of the farm or closely held business by the decedent or a member of his family in 5 years out of the 8 years immediately preceding the decedent's death.

For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its special use value. The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

Qualifying real property.—Real property may qualify for special use valuation if it is located in the United States and if it is devoted to either (1) use as a farm for farming purposes or (2) use in a trade or business other than farming. In the case of either of these qualifying uses, the Congress intended that there must be a trade or business use. The mere passive rental of property will not qualify. However, where a related party leases the property and conducts farming or other business activities on the property, the real property may qualify for special use valuation. For example, if A, the decedent, owned real property which he leased for use as a farm to the ABC partnership in which he and his sons B and C each had a one-third interest in profits and capital, the real property could qualify for special use valuation. However, if the property is used in a trade or business in which neither the decedent nor a member of his family materially participates, the property would not qualify.

In general, a "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities. Farms also include orchards and woodlands. In deciding whether real property is used as a farm for farming purposes, the activities engaged in on the real property are determinative. In addition to cultivation of the soil and raising or harvesting of agricultural or horticultural commodities and preparing such commodities for market, the term "farming purposes" as used in these provisions includes the planting, cultivating, caring for or cutting of trees, and the preparation (other than milling) of trees for market.

[1] Whether there has been "material participation" by an individual in the operation of a farm or closely held business is to be determined in a manner similar to the manner in which material participation is determined for purposes of the tax on self-employment income with respect to the production of agricultural or horticultural commodities under present law. (Sec. 1402(a)(1)).

As indicated above, real property which is used in a trade or business other than the trade or business of farming may also qualify for special use valuation so long as the property was used in a trade or business in which the decedent or a member of his family materially participated prior to the decedent's death. This is true even though the party carrying on the business was not the decedent or a member of his family so long as the decedent or a member of his family materially participated in the business.

In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for special use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property.[2] Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use. On the other hand, elements of value which are not related to the farm or business use (such as mineral rights) are not to be eligible for special use valuation. For example, if there is an oil lease on a farm, the full value of the lease is to be taken into account for estate tax purposes. Similarly, if there are buildings or other improvements on (or contiguous with) the farm and the buildings or other improvements are neither functionally related to the farm nor qualify as a farmhouse and related improvements, these buildings and other improvements are not treated as qualified farm real property.

The Act directs the Treasury Department to prescribe regulations setting forth the application of these special use valuation rules (and the security requirement, discussed below) to situations involving otherwise qualifying real property held in a partnership, corporation, or trust which, with respect to the decedent, is an interest in a closely held business. Trust property shall be deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a present interest in that trust property. The Congress intended that a decedent's estate generally should be able to utilize the benefits of special use valuation where he held the qualifying real property indirectly, that is, through his interest in a partnership, corporation, or trust, but only if the business in which such property is used constitutes a closely held business (as defined in section 6166, as added by the Act) and the real property would qualify for special use valuation if it had been held directly by the decedent.

Valuation methods: (a) Farm method.—If a farm qualifies for special use valuation under this new provision, its value is generally to be determined by dividing:

> (i) The excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual State and local real estate taxes for such comparable land by

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[2] Residential buildings or related improvements shall be treated as being on the qualified real property if they are on real property which is contiguous with qualified real property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property.

(ii) The average annual effective interest rate for all new Federal Land Bank loans.

For purposes of this rule, each average annual computation is to be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death.

The special farm valuation method is provided to permit the executor, in many situations, to achieve a substantial amount of certainty in arriving at use valuation for farmland as well as to eliminate nonfarm factors in valuing farmland. Since this method involves a mathematical computation in which the amount of the annual rental may in many cases be determinable with reasonable certainty and the capitalization rate is determinable, this method should offer three advantages. First, it should reduce subjectivity, and thus controversy, in farm valuation. Second, it should eliminate from valuation any values attributable to the potential for conversion to nonagricultural use. Third, it should also eliminate as a valuation factor any amount by which land is bid up by speculators in situations where nonagricultural use is not a factor in inflated farmland values.

However, this special farm valuation method is not applicable where—

(i) It is established that there is no comparable land from which the average annual gross cash rental may be determined, or

(ii) The executor elects to have the value of the farm determined by applying the multiple factor method (described below).

(b) *Multiple factor method.*—The Act sets forth the following list of factors that are to be taken into account in determining special use valuation for qualifying real property not used in farming and for qualifying farm real property if the special farm method is not used:

(1) The capitalization of income that the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration and similar factors,

(2) The capitalization of the fair rental value of the land for farmland or closely held business purposes,

(3) Assessed land values where the State provides a differential or use value assessment law for farmland or land used in closely held businesses.

(4) Comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price, and

(5) Any other factor which fairly values the farm or closely held business value of the property.

Recapture.—The Act provides that if, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are to be recaptured. This recapture provision is to apply not only where the qualified real property is sold (or exchanged in a taxable transaction) to nonfamily members, but also where the property is disposed of to nonfamily members in a tax-free exchange (e.g., under section 1031) or where the property is disposed of under an involuntary conversion, rollover, or similar transaction (which is nontaxable by reason of section 1033 or 1034).[3] The preceding sentence does not apply to an involuntary conversion or condemnation if the proceeds are reinvested in the real property which originally qualified for special use valuation.

The amount of the tax benefit potentially subject to recapture is the excess of the estate tax liability which would have been incurred had the special use valuation provision not been utilized over the actual estate tax liability based on the special use valuation provisions. This amount is called the "adjusted tax difference". Where more than one qualified heir receives qualified real property with respect to which special use valuation has been elected or receives an interest in such property, the adjusted tax difference is to be allocated among the property interests in proportion to their respective reductions in value.

In general, if a recapture event occurs within 10 years of the decedent's death, the amount of the additional or "recapture" tax imposed with respect to the interest shall be an amount equal to the lesser of the adjusted tax difference attributable to this interest or the excess of the amount realized with respect to the interest over the value of the interest determined with the special use valuation. In cases where there is a cessation of qualifying use or a sale or exchange at other than arm's length, the amount of the additional tax imposed will be the lesser of the adjusted tax difference attributable to the interest or the excess of the fair market value of the interest over the special use valuation. If the recapture event occurs more than 10, but less than 15, years after the decedent's death (but prior to the death of the qualified heir), the amount subject to recapture (as described in the preceding two sentences) is phased out on a ratable monthly basis.

Disposition, or cessation of qualified use, of a portion of an interest may result in a full or partial recapture. Also, if there are two recapture events with respect to one property interest (which may occur where, for instance, the qualified heir changes the use of the property and later sells it), a recapture tax will be imposed on the first "recapture event," but no recapture tax will be imposed upon the second "recapture event."

A qualified heir is expressly made personally liable for the recapture tax imposed with respect to his interest in qualified property.

In general, if the qualified heir dies without having disposed of the property or converted it to a nonqualified use or a period of 15 years from the decedent's death lapses, the potential liability for recapture will cease. Thus, if the decedent leaves qualified property to two of his children as tenants in common and the special use valuation is elected,

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[3] It was intended, however, that the Treasury Department will provide by regulations that the disposition of qualified property by tax-free transfer to a corporation pursuant to section 351 or to a partnership pursuant to section 721 is not to result in application of the recapture tax: if (1) the qualified heir retains the same equitable interest in the property; (2) if the corporation or partnership would, with respect to the qualified heir, be considered a closely held business within the meaning of section 6166; and (3) if the corporation or partnership consents to personal liability for the recapture if it disposes of the real property or ceases to use the property for qualified purposes during the perid in which recapture may occur.

the death of one of the children would free his interest in the property from any further potential liability for the recapture tax. However, if the decedent leaves qualified real property to two or more qualified heirs with successive interests in the property and the special use valuation is elected, potential liability for the recapture tax is not diminished, and none of the property is to be released from potential liability for the recapture tax, until the death of the last of the qualified heirs (or, if earlier, upon the expiration of 15 years from the date of the death of the decedent).

Since a sale, exchange, or other disposition (such as a gift) by one qualified heir to another qualified heir is not treated as a recapture event, the Act provides that the second qualified heir is to be treated as if he had received the property from the decedent. Thus, the second qualified heir steps into the shoes of the first heir and becomes liable for the recapture tax, and the special estate tax lien for this potential recapture tax remains on the property, even though the second qualified heir may have paid the first qualified heir full fair market value for the qualified property.

While the recapture tax is generally treated as a separate estate tax, it is treated as a tax on the estate of the decedent for purposes of the previously taxed property credit. If the qualified heir dies within 10 years of the time of the death of the decedent but after a recapture event has occurred, this recapture tax would be utilized in computing the previously taxed property credit. However, it would be treated as having been imposed as of the date of the decedent's death, rather than at the time the actual recapture event occurred.

The "cessation of qualified use" which constitutes a disposition occurs if (1) the qualified property ceases to be used for the qualified use under which the property qualified for special use valuation or (2) during any period of 8 years ending after the date of the decedent's death and before the date of the death of the qualified heir, there have been periods aggregating 3 years or more during which there was no material participation by the qualified heir or a member of his family in the operation of the farm or other business.

Special lien on qualified real property.—The Act provides a special lien on all qualified farm or closely held business real property with respect to which an election to use the special use valuation provision has been made. This lien is to continue until the tax benefit is recaptured or until the potential liability for recapture ceases (i.e., the qualified heir dies or a period of 15 years from the decedent's death lapses). Under this provision, the Treasury Department is authorized to set forth regulations under which other security could be substituted for the real property.

Election and agreement.—Under the Act, the election to use this special use valuation may be made not later than the time for filing the estate tax return, including extensions.

One of the requirements for making a valid election is the filing with the estate tax return a written agreement signed by each person in being who has an interest (whether or not in possession) in any qualified real property with respect to which the use valuation is elected. This agreement must evidence the consent of each of these parties to the application of the recapture tax provisions to the property. As noted above, such a consent also amounts to a consent to be personally liable for any recapture tax imposed with respect to the qualified heir's interest in the qualified property. The Congress believed that each person receiving an interest subject to potential recapture should agree to this potential liability, especially since that person may not have received the tax benefits from the special use valuation (because, for example, the estate tax burden is borne by a residuary legatee who did not receive farm property).

Statute of limitations.—The Act provides for an extension of the statutory period for assessment and collection of the recapture tax until 3 years after the Internal Revenue Service is notified that an event has occurred which results in the imposition of this tax.*

Effective date

These provisions are to apply to the estates of decedents dying after December 31, 1976.

4. Extension of Time for Payment of Estate Tax (sec. 2004 of the Act and secs. 303, 6161, 6163, 6166, 6503, 6601, and 6324A of the Code)

Prior law

Generally, an estate tax return is due nine months after the decedent's death. Except in certain specified situations, payment of the estate tax is required to be made with the return.

However, prior law contained two provisions which permit the estate tax to be paid over a period of up to ten years after the due date of the return. First, the Internal Revenue Service may extend the time for payment of tax up to ten years if it found that a current payment of the tax would result in "undue hardship" to the estate (sec. 6161(a)(2)). Second, an executor may elect to pay the estate tax in installments over two to ten years where the estate consists largely of interests in a closely held business or businesses (sec. 6166).[1]

Discretionary extensions.—In order to qualify under the first provision, the executor must have been able to show that the payment of the estate tax on the due date would cause undue hardship. The term "undue hardship" required more than a showing of reasonable cause or inconvenience to the estate. In general, undue hardship could be established in a case where the assets in the gross estate which must be

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*The Act provides that the lien imposed by new section 6324B must be filed to have priority against any purchaser, holder of a security interest, mechanic's lienor, or a creditor. It also provides that the same general priority and super priorities rules apply as apply with respect to the lien under section 6324A. If the lien provided for by section 6324B applies, the property is not to be subject to the general estate tax lien provided under section 6324.

[1] There are also other provisions under which an executor may obtain a lesser extension of time for the payment of estate tax. Under section 6161(a)(1), the Service may extend the time for payment of all or a portion of the estate tax for up to one year, if there is reasonable cause for such extension. "Reasonable cause" is a much easier test to meet than "undue hardship"; it could be satisfied by showing that the executor needs time to collect receivables or to convert assets into cash.

Under section 6161(b), an executor could obtain an extension of up to four years to pay a deficiency if he could show that the payment on the date the payment was due would cause undue hardship to the estate.

If the value of a reversionary or remainder interest in property is included in the gross estate, the executor may elect to have the payment of the portion of the tax attributable to the interest deferred until six months after the termination of the preceding interest or interests in the property (sec. 6163(a)). If the executor could show that payment at the end of this period would result in undue hardship to the estate, an additional extension or extensions of up to three years could be obtained (sec. 6163(b)).

liquidated to pay the estate tax can only be sold at a sacrifice price. Also, undue hardship could be established where a farm or closely held business could be sold to unrelated persons at a price equal to its fair market value, but the executor seeks an extension of time to raise other funds for the payment of the estate tax.

Automatic extensions for closely held businesses.—Under the second provision, an executor may elect to pay the estate tax attributable to an interest in a farm or other closely held business in installments over a period not to exceed 10 years. In order to qualify under this provision, the value of the interest in the closely held business must exceed 35 percent of the value of the gross estate or 50 percent of the taxable estate of the decedent. For this purpose, the term "interest in a closely held business" means an interest as sole proprietor in a trade or business; an interest as a partner in a partnership having not more than 10 partners, or in which the decedent owned 20 percent or more of the capital; or ownership of stock in a corporation having not more than 10 shareholders, or in which the decedent owned 20 percent or more of the voting stock.

If a decedent's gross estate includes more than 50 percent of the value of each of two or more closely held businesses, the businesses can be treated as a single closely held business in determining whether either the 35 percent or 50 percent test is satisfied.

Under prior law (sec. 6166(h)), an acceleration of payment of the unpaid installments occurred on the happening of any of the following events:

(1) The estate has undistributed net income in any taxable year after its fourth taxable year;

(2) There is failure to pay an installment;

(3) There is a withdrawal of funds from the business that equals or exceeds 50 percent of the value of the trade or business (and such withdrawal is attributable to the decedent's interest); or

(4) There is a disposition of 50 percent or more of the value of the decedent's interest in the business.[2]

Under either of these provisions, the Internal Revenue Service may, if it deems it necessary, require the executor to furnish a bond for the payment of the tax in an amount not more than double the amount of the tax for which an extension is granted. In addition, the executor is personally liable for the payment of the tax unless he is discharged upon payment of the tax due and upon furnishing any bond or security which may be required for the tax which is not presently due because of an extension of time for payment.

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[2] Redemptions of stock under section 303 (relating to certain redemptions for the payment of estate taxes) do not count as withdrawals for this purpose. If there were such a redemption, the value of the trade or business in computing the extent of the withdrawal would be the value reduced by the proportionate share of the redemption. The exception is inapplicable unless on or before the date of the first installment of the estate tax which becomes due after redemption, there is paid on account of the estate tax an amount not less than the value of the property and money distributed (sec. 6166(h)(1)(B)).

When the executor has knowledge of any transaction that results in a withdrawal of funds from the business, or a disposition of a qualifying closely held business, sufficient to cause acceleration of payment, he must notify the District Director in writing within thirty days.

Redemptions to pay death taxes.—Under the income tax law (sec. 303), a qualified redemption of stock to pay estate taxes will be taxed as capital gain rather than as a dividend distribution taxed as ordinary income, even though a similar redemption would have been treated as a dividend if the stock had been redeemed from the decedent during his lifetime. To qualify for this treatment under prior law, the value of the stock redeemed, plus the value of the other stock of the redeeming corporation includible in the estate, must have been more than either 35 percent of the gross estate or 50 percent of the taxable estate. The value of the stock redeemed could be no greater than the sum of all death taxes (and interest) plus funeral and administration expenses allowable as an estate tax deduction. The time generally allowed for the redemption was three years and ninety days after the estate tax return was filed.[3]

Interest on amounts not paid on due date of return.—In general, interest is payable by a taxpayer to the government if the tax is not paid on the due date of the return (disregarding extensions). Prior to July 1, 1975, the interest rate on extended (or late) tax payments was generally 6 percent per year. However, there were a number of special situations where a 4 percent annual rate was specified. These included: (1) where the estate tax attributable to a closely held business included in a decedent's estate could be paid in up to 10 annual installments; (2) where an executor elected deferred payment of the estate tax imposed with respect to the value of a reversionary or remainder interest included in the gross estate; and (3) where the Internal Revenue Service, after determining that the payment of any part of the estate tax on any due date would impose undue hardship upon the estate, granted an extension of time for payment.

In 1975, Congress changed the law relating to interest on tax payments owed to the government (or on overpayments owed taxpayers by the government). In general, the changes increased the 6 percent rate to 9 percent and provided that the interest rate was to be adjusted periodically by the Treasury Department to keep it approximately equal to 90 percent of the prime rate quoted by commercial banks to large businesses (as regularly published by the Board of Governors of the Federal Reserve System). Effective on February 1, 1976, the interest rate was decreased from 9 percent to 7 percent.[4]

The amendments made in 1975 also eliminated the special 4 percent rate. At that time, it was noted that

> "although an extension of time to pay a tax may be appropriate in certain cases in order to avoid unnecessary hardships, the committee sees no sound reason to permit some taxpayers to pay interest at a lower rate than other taxpayers are required to pay on underpayments of tax. Relief from the hardship of paying taxes in a lump sum should not also mean that the interest rate should be reduced if payments are made in installments. This is particularly so if a closely held business owned by an estate . . . is or can be earning a significantly higher return on the tax money which it presently can, in

[3] Under certain circumstances, stock could be redeemed for a period which does not end prior to 90 days after a decision of the Tax Court becomes final.
[4] See Technical Information Release No. 1407, October 14, 1975.

effect, borrow from the Government at 4 percent." (S. Rep. No. 93-1357, 93rd Cong., 2d Sess., 19-20).

Reasons for change

These provisions have proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business or other illiquid assets. In many cases, the executor was forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax. This may have occurred even when the estate qualified for the 10-year extension provided for closely held businesses. In these cases, it may have taken several years before a business could regain sufficient financial strength to generate enough cash to pay estate taxes after the loss of one of its principal owners. Moreover, some businesses were not so profitable that they yielded enough to pay both the estate tax and interest especially if the interest rate was high.

On the other hand, where a substantial portion of an estate consisted of illiquid assets other than a farm or closely held business, it had been extremely difficult to obtain an extension on the grounds of "undue hardship" because the Internal Revenue Service generally took a restrictive approach toward granting such extensions. The Congress believed that additional relief was needed by estates with liquidity problems.

In addition, many executors found it both difficult and expensive to obtain a bond to satisfy the extended payment requirements. Therefore, many executors refused to elect the extended payment provisions because they remained personally liable for tax for the entire length of the extension.

The Congress also believed that it was appropriate to revise the provisions allowing capital gains treatment of a redemption of stock in a closely held business to provide for the payment of estate taxes and other deathtime debts. In general, it appeared desirable to lengthen the period for redemption of stock in cases where an automatic election to pay the estate tax in installments has been made, while restricting the benefit of the redemption provisions to persons whose interest in the estate is chargeable with the debts and taxes of the decedent's estate, and restricting the availability to situations in which a large portion of the estate consists of an interest in a closely held business or businesses.

Explanation of provisions

In general.—The Act makes four changes in prior law.

First, the Act substitutes a "reasonable cause" standard for the "undue hardship" standard under prior law in the case of the ten-year discretionary extension of time for payment of estate tax (sec. 6161(a)(2)). For this purpose, the term "reasonable cause" is to have the same meaning as the term is used for granting discretionary extensions of up to twelve months (regs. § 20.6161-1(a)).

Second, the Act retains the present ten-year extension for payment of estate tax (renumbered as sec. 6166A) where the value of a closely held business exceeds 35 percent of the value of the gross estate or 50 percent of the taxable estate of the decedent.

Third, the Act adopts a new 15-year extension as an alternative for extending the payment of estate tax attributable to a closely held business where the business constitutes more than 65 percent of the decedent's adjusted gross estate.

Fourth, the Act provides a special lien procedure for payment of the estate tax deferred under either of the two extensions for closely held businesses. The executor will be discharged from personal liability where this special lien procedure is followed. Moreover, substantial revisions are made in the provisions relating to redemptions of corporate stock to pay estate taxes and funeral and administration expenses.

Automatic extensions in cases involving closely held businesses.— The Act provides a 15-year period for the payment of the estate tax attributable to the decedent's interest in a farm or other closely held business. Under the Act, the executor may elect to defer the estate tax (but not interest on the tax) for a period of up to 5 years and thereafter pay the tax in equal annual installments over the next 10 years.

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 expenses, indebtedness, and losses.[5]

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. However, interest for the first 5 years is payable annually.[6] Thereafter, pursuant to the executor's initial election, the principal amount of the estate tax liability may be paid in from 2 to 10 installments. The Act provides that a special 4-percent interest rate is allowed on the estate tax attributable to the first $1 million of farm or other closely held business property, and interest on amounts of estate tax in excess of this amount will bear interest at the regular rate for interest on deferred payments (currently 7%).[7]

Allowing the reduced interest rate at a 4-percent level for a limited amount of tax was intended to reflect the problems that smaller businesses have in generating enough income and cash flow to pay interest at a normal rate and amortize the principal amount of the estate tax liability. It was felt that the 5-year deferral period plus the reduced interest rate on the tax attributable to the first $1 million in value of a closely held business should, in most cases, give the business time to generate sufficient funds to pay the estate tax and interest thereon without the business having to be sold to satisfy the estate tax liability

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[5] The expenses, indebtedness, and losses which reduce the gross estate for purposes of the 65% test shall be determined on the basis of the facts and circumstances in existence on the date (including extensions) for filing the estate tax return (or, if earlier, the date on which the return is filed).

[6] Where a deficiency with respect to amounts subject to a section 6166 extension is assessed during the initial five-year period, interest that has already accrued on the deficiency is due upon notice and demand.

[7] For purposes of determining the amount of tax which qualifies for this 4% interest rate, the statutory provision has the effect of assuming that the closely held business is the item in the decedent's estate which is taxed at the lowest rates. The reasons for adopting this proposal were that it provides simplicity in computation and gives the same benefit to relatively small estates with a $1 million business as it does to larger estates with a similar business. This is a somewhat different approach from that contained in the determination of what tax is attributable to the business and what tax is attributable to other assets in the estate for purposes of computing the amount of tax which is eligible for deferral under section 6166(a)(2), which provides for a pro rata allocation.

(including a period for adjustment after the loss of one of the principal owners).

The Act generally retains the definition of existing law relating to an interest in a closely held business. However, it expands the definition to include situations where the decedent had a 20 percent capital interest in the partnership or the partnership had 15 or fewer partners (rather than 10 or fewer, as required by prior law), and situations in which the decedent had at least a 20 percent of the voting stock of the business or the corporation had 15 or fewer shareholders (rather than 10, as required by prior law). The Act also adds certain rules which treat community property and property which is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common, as though the property were owned by one shareholder or one partner, as the case may be, for purposes of satisfying the numerical test for shareholders or partners. Also, in order to prevent avoidance of the shareholder or partner limitations by the use of partnerships, trusts, or tiers of corporations, the Act provides that property (including stock or a partnership interest) owned directly or indirectly by or for a corporation, partnership, estate, or trust are to be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. However, beneficiaries are counted for apportionment only if they have present interests in the trust.

In the case of a closely held business which is engaged in farming, the Act provides that the interest in the business includes an interest in residential buildings and related improvements on the farm if they are occupied on a regular basis by the owner or lessee of the farm or by persons employed by the owner or lessee for purposes of operating or maintaining the farm. Also, the Act provides that the value included in these computations is to be the value determined for purposes of the estate tax. Thus, in the case of a farm where the executor has elected special use valuation (under section 2032A), the special use valuation is to be treated as the "value" for purposes of this extended payment provision (sec. 6166).[8]

The Act also liberalizes the rules relating to when 2 or more businesses may be aggregated for purposes of determining (1) whether the estate qualifies under the 65 percent test and (2) the amount of tax to be deferred. Prior law required that more than 50 percent of the total value of each business must be included in the decedent's estate before the businesses are aggregated for purposes of this extended payment provision (sec. 6166). The Act reduces this 50 percent requirement to a requirement that more than 20 percent of the total value of each such business is included in the decedent's estate. This liberalization is intended to recognize that even minority interests in multiple businesses can cause the decedent's estate to be illiquid.[9]

The Act essentially retains provisions of prior law which provide for acceleration of the deferred tax when all or a significant portion of the closely held business is disposed of or liquidated or upon

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[8] A farmhouse or related improvements shall be treated as being on the farm if it is contiguous with land used in farming or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property.

[9] The Act allows the spouse's community property interest (or interest as a joint tenant, tenant by the entirety, or tenant in common) to be aggregated with the decedent's interest in determining whether this 20 or 50 percent aggregation limit is met.

failure to pay an installment when due. However, liquidation or disposition of one-third (rather than one-half as under prior law) of the business is to be sufficient to cause acceleration.[10]

The Act also allows the executor to pay any estate tax deficiencies in installments if the estate qualifies for the election, but the executor has not made the election. In general, this is to apply both to situations where on the basis of the estate tax return, as filed, the estate was eligible to make the election but did not do so (for instance, because there was enough cash in the estate to pay the tax liability shown on the return), and to situations where the adjustments on the return on audit increase the valuation of the closely held business or businesses to the point where the estate is now eligible for the automatic election. If an executor elects to pay a deficiency in installments under this provision, but has not so elected with respect to any portion of the estate tax liability shown on the return, interest is to be paid in the manner prescribed by the Secretary, consistent with the provisions of section 6166(f).

The Act retains the present ten-year extension for payment of estate tax (renumbered as sec. 6166A) where the value of a closely held business exceeds 35 percent of the value of the gross estate or 50 percent of the taxable estate of the decedent.

Lien in lieu of executor's personal liability or bond.—The Act also provides a special lien for payment of the deferred taxes attributable to the closely held business in situations where the executor has made an election under the extended payment provision rules (section 6166 or 6166A). This new lien provision (section 6324A) is elective, and an executor and all parties who have an interest in the property which is to be subject to the lien must file an agreement consenting to the creation of the lien and designating a responsible person to be the agent for the beneficiaries of the estate and the persons who consented to the creation of the lien for purposes of dealings with the Internal Revenue Service.

This lien is to apply to real property and other assets which can be expected to survive the period for payment of tax under this provision. Where this lien procedure is followed and a party is designated to make estate tax payments and receive and transmit notices from the Internal Revenue Service, the executor is to be discharged from personal liability. Under this provision, the Internal Revenue Service will have no authority to require a bond except to the extent that there is not adequate security for the unpaid principal amount of tax liability plus interest. The value of property which the Internal Revenue Service may require under this provision may not exceed the sum of the deferred principal amount of the taxes plus the aggregate amount of interest to be payable over the payout period. In valuing property to be subject to the lien, the value is to be determined as of the due date for the estate tax return and is to be reduced by taking into account other prior encumbrances, such as mortgages and liens under the provision (sec. 6324B) relating to farm valuation recapture.

[10] Prior law (section 6166) also requires acceleration to the extent that the estate has undistributed net income for any taxable year after its fourth taxable year. Since, under section 6166 as amended by the Act, the first payment may not be due until 5 years after the estate tax return is filed, this requirement is amended to require acceleration only where the estate has undistributed net income for any taxable year ending on or after the due date for the first installment.

If the property covered by the agreement or proposed to be covered by the agreement is insufficient, the Service may accept a bond for the difference. Also, additional lien property can be required by the Service if the value is initially less or declines below the sum of the unpaid deferred amount of taxes and the aggregate interest amount. If additional property is not furnished as security or other security is not furnished within 90 days after notice and demand by the Internal Revenue Service, such failure is an event which is to accelerate payment.

This special lien is in lieu of the regular estate tax lien (under sec. 6324) as to the property subject to the special lien. The Act requires that this new lien must be filed to be valid as against any purchaser, holder of the security interest, mechanic's lienor, or judgment lien creditor. However, once filed, it need not be refiled every 6 years as is required of tax liens generally. This new lien arises when the executor is discharged from liability or, if earlier, when the notice of lien is filed. It continues until liability for the deferred amount of taxes is satisfied or becomes unenforceable by reason of lapse of time.[11]

The lien is inferior to certain so-called "superpriorities." These superpriorities are essentially the same as those under the provisions of present law relating to most other tax liens (see sec. 6323(b)). Thus, even though a notice of lien has been filed, the lien is not valid against real property tax and special assessment liens (even those which come into existence after the date upon which the notice of lien is filed). Also, this lien is inferior to a mechanic's lien for repairs and improvements, or a real property construction or improvement financing agreement, if, in the latter case, the security interest came into existence before or after notice of the tax lien was filed. If the Internal Revenue Service files a notice that payment of the deferred amount has been accelerated, tax liens shall take priority over subsequent mechanic's liens or real property construction or improvement financing agreements, but not real property tax or special assessment liens.

Reasonable cause standard for discretionary extensions.—The Act allows discretionary extensions of up to 10 years to pay the estate tax for reasonable cause, rather than for "undue hardship", as under prior law. Similarly, a discretionary extension of time to pay the estate tax attributable to a remainder or reversionary interest includible in the estate may be obtained upon a showing of reasonable cause (sec. 6163(b)). Also, the standard for extensions of time to pay deficiencies of estate taxes is changed to require only reasonable cause.

In these situations involving discretionary extensions of time to pay the tax, or to pay deficiencies, the normal rules relating to interest (which currently requires 7 percent interest) are to apply.

Distributions and redemption of stock to pay death taxes.—Under prior law, to qualify for capital gains treatment (under section 303), the redemption must be accomplished by a corporation (or, in certain cases, corporations) whose stock comprises more than 35 percent of the value of the decedent's gross estate, or more than 50 percent of the taxable estate, and the amount of the redemption so treated was

[11] A lien can become unenforceable by reason of lapse of time when, for instance, there is an accelerating event, the Internal Revenue Service is notified, and it fails to assess a deficiency within 3 years of such notification.

limited to the sum of the estate taxes, State death taxes, administration expenses, and funeral expenses. The Act changes the 35 percent and 50 percent alternative tests to a test which requires that the value of the corporate stock included must exceed 50 percent of the value of the gross estate reduced by the sum of the losses, debts, and administration expenses of the estate. The Act extends the time for such a redemption in cases where an election has been made (under sec. 6166) until the due date of the last installment. However, for any redemption made more than four years and ninety days after the decedent's death, capital gains treatment is available only for a distribution in an amount which is the lesser of: (1) the amount of the qualifying death taxes and funeral and administration expenses which are unpaid immediately before the distribution or (2) the aggregate of these amounts which are paid within one year after the distribution.

Under prior law, if the stock was included in a decedent's gross estate, it could be redeemed from the decedent's estate, from a beneficiary, or from another party (such as a donee of a gift in contemplation of death), even though the owner of the stock was not chargeable with any portion of the liability of the estate for debts, expenses, or taxes. The Act amends the Code to require that capital gains treatment (under sec. 303) will apply to the distribution by a corporation only to the extent that the interest of a shareholder is reduced either directly or through a binding obligation to contribute toward the payment of debts, expenses, or taxes.

Thus, in general, the changes made by the Act are designed to make this special capital gains treatment available only where the closely held business interest constitutes a substantial part of the estate of the decedent and where the party whose shares are redeemed actually bears the burden of the estate taxes, State death taxes, or funeral and administration expenses in an amount at least equal to the amount of the redemption. The extended period for redemption is intended to more closely correlate the special capital gains and the extended payment provisions, particularly in that it would allow the corporation to build up liquid assets and redeem stock so that the payment of estate taxes might be made at any time throughout the period for making the installment payments of tax.

5. Carryover Basis (sec. 2005 of the Act and secs. 691, 1014, 1015, 1016, 1023, 1040, 1246, 6039A, and 6694 of the Code)

Prior law

Under prior law, the cost or basis of property acquired from or passing from a decedent was its fair market value at the date of death (or the date of the alternate valuation date if that date is elected for estate tax purposes).[1] Thus, if the fair market value of the property had appreciated after the decedent acquired it, the resulting gain would never be subject to income tax. On the other hand, if the property depreciated in value after the decedent acquired it, the loss could never be deducted for income tax purposes. The basis of

[1] For purposes of this discussion, a reference to the fair market value at the date of the decedent's death will include reference to the value of the property on the alternate valuation date.

property acquired from or passing from the decedent is often referred to as "stepped-up basis." (Although basis may have been adjusted upward or downward at death, upward adjustments were more common, partly because property tends to appreciate over time, and partly because individuals may have disposed of their loss property prior to death, but tended to hold property which had appreciated in order that the beneficiaries would receive the "step-up.")

For the purposes of determining what property was given a stepped-up basis, the test was generally whether the property was included in the gross estate of the decedent. In addition, prior to the Act the surviving spouse's share of community property was treated as if it were acquired from the decedent (and received a stepped-up basis) even though that portion of the community property was not includible in the gross estate of the decedent.

Where property is transferred by gift, the basis of the property in the hands of the donee is generally the same as the donor's basis. However, under prior law, this "carryover basis" was increased by the amount of any gift taxes paid on the transfer by gift, but not to exceed the property's fair market value as of the date of the gift. An exception to the carryover basis rule is provided in computing any loss resulting from the sale or other disposition of property acquired by gift. Under that exception, the basis of the asset for purposes of computing loss is the lesser of the fair market value of the property on the date of gift or the basis of the property in the hands of the donor. Where the asset is sold at a price greater than the fair market value at the date of gift, but less than the basis of the donor, then neither gain nor loss is recognized on the transaction.

Reasons for change

Prior law resulted in an unwarranted discrimination against those persons who sell their property prior to death as compared with those whose property was not sold until after death. Where a person sells appreciated property before death, the resulting gain is subject to the income tax. However, if the sale of the property could be postponed until after the owner's death, all of the appreciation occurring before death would not be subject to the income tax.

This discrimination against sales occurring before death created a substantial "lock-in" effect. Persons in their later years who might otherwise sell property were effectively prevented from doing so because they realized that the appreciation in that asset would be taxed as income if they sold before death, but would not be subject to income tax if they held the asset until their death. The effect of this "lock-in" was often to distort the allocation of capital between competing sources.

In order to eliminate these problems, Congress believed that the basis of property acquired from or passing from a decedent should have the same basis in the hands of the recipient as it had in the hands of the decedent, i.e., a "carryover basis." This will have the effect of eliminating the unwarranted difference in treatment between lifetime and deathtime transfers.

However, in order to prevent a portion of the appreciation from being taxed by both the estate tax and the income tax, the Congress believed that the carryover basis should be increased by Federal and

State death taxes attributable to the appreciation in value. In addition, in order to prevent beneficiaries of smaller estates from paying tax on appreciation accruing before the decedent's death, the Congress concluded that each estate should have a minimum basis in all of its carryover basis assets of at least $60,000. Finally, in order to not subject appreciation arising prior to the Act to income taxation, the Act provides that the basis of assets acquired from a decedent which were held by that decedent on December 31, 1976, shall be stepped-up to their value on that date for purposes of determining gain.

Explanation of provision

Under the Act, the basis of most property acquired from or passing from a decedent who dies after December 31, 1976, is no longer to be stepped up (or stepped down) to reflect the fair market value of the property on the date of death. Property which is no longer entitled to this adjustment based on fair market value is refererd to, under the Act, as "carryover basis property." Property which is not carryover basis property continues to be governed by the basis rules of prior law.

The Act adds a new provision (sec. 1023) to provide rules for determining the basis of "carryover basis property." In general, the basis of carryover basis property acquired from or passing from a decedent dying after December 31, 1976, is to be the decedent's basis immediately before his death with certain adjustments discussed below.

Where the carryover basis rules apply, the gain on the sale or other disposition of property received from a decedent is to be taxed to the recipient who sold, or otherwise disposed of, the property. This gain will reflect any decrease in basis of the property in the hands of the decedent from depreciation, depletion, or amortization deductions taken by him. Therefore, the gain on the sale of such property is to be characterized as ordinary income to the extent provided by the recapture provisions (secs. 1245, etc.) of the Code.

In the case of property passing by death, it is not possible to selectively transfer only loss assets since all of the assets of the decedent must pass at the death of their owner. Consequently, the Act does not generally limit the adjusted carryover basis to the fair market value of property acquired from or passing from a decedent. Thus, in the case of investment assets held by the decedent, losses as well as gains are to be measured by reference to the basis of the property in the hands of the decedent.

However, the Congress believed that it is inappropriate to permit the losses that typically occur in connection with personal and household assets to offset gains attributable to the investment assets of the decedent. Generally, these losses would have been treated as nondeductible personal losses if they had been realized by the decedent during his life. Thus, the Act provides that, for purposes of computing loss on the sale or other disposition of personal or household effects, the basis of these items cannot exceed their fair market value on the applicable valuation date. Where the amount realized on the sale of a personal item is greater than its fair market value at the date of death of the decedent but less than the basis of the asset in the hands of the decedent, then no gain or loss will be recognized on the transaction.

For this purpose, personal and household effects generally include clothing, furniture, sporting goods, jewelry, stamp and coin collections, silverware, china, crystal, cooking utensils, books, cars, televisions, radios, stereo equipment, et cetera.

Definition of carryover basis property.—Generally, the term "carryover basis property" includes all property acquired from or passing from the decedent (within the meaning of section 1014(b)). Thus, the term generally covers all property which receives a stepped-up basis under existing law. However, there are a number of exceptions to the general rule.

First, the Act excepts life insurance on the decedent's life from the definition of carryover basis property. Second, the Act makes a number of other exceptions for property where the income attributable to it is already taxed to the recipient under present law.[2] In this case, it is unnecessary to include the property within the scope of the new carryover basis rules.

There are often numerous items such as clothing, etc., which the decedent owned at his death, for which it would be extremely difficult for the executor to determine their carryover bases. Moreover, in most cases, the fair market value of these items is less than their adjusted bases. To deal with this situation, the Act permits the executor of the estate, in effect, to exempt up to $10,000 worth of household and personal effects of the decedent from the carryover basis rules by making an election designating which items are not to receive carryover basis treatment. Where the executor makes such an election, the personal and household effects to which the election applies will receive a stepped-up basis, as under prior law.

Adjustments to carryover basis.—In addition to a transitional "fresh start" adjustment described below, the Act provides three adjustments that are to be made to the adjusted basis which is carried over from the decedent. Under the first adjustment, the basis is increased by Federal and State estate taxes paid by the estate attributable to the appreciation in the carryover basis property. Secondly, after the adjustment for Federal and State estate taxes, if $60,000 exceeds the adjusted bases of all carryover assets, the bases of appreciated carryover basis property is increased by the excess. Finally, the basis of carryover basis property is increased by any State death taxes which are paid by the distributee of carryover basis property and which are attributable to any remaining appreciation in carryover basis property received by that distributee. However, in no event may the basis of any asset be increased by the three adjustments in excess of its fair market value on the date of the decedent's death.

For purposes of determining the appreciation of carryover basis property and the limit on the adjustments in the carryover basis of the property, the fair market value of property is considered to be its value for Federal estate tax purposes. Thus, if property is valued under the alternate valuation method or the special farm or closely held business valuation method previously discussed, that alternate or special

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[2] Sections 72, 402, 403, 423(c), 424(c)(1), 691, and 1014(b)(5) (and sec. 1014(b)(9) with respect to property included in the gross estate where the donee has sold it before the decedent's death). For purposes of the exception with respect to payments and distributions under a deferred compensation plan life insurance proceeds payable under the plan and excludible under section 72(m)(3) are to be treated as taxable to the beneficiary and thus excluded from the term "carryover basis property."

value is to be used to determine the amount of appreciation for purposes of making all the adjustments to the carryover basis.

It is also intended that where property passes to an estate which has unrealized appreciation which would have been subject to recapture (under sec. 1245 or sec. 1250) if it had been sold by the decedent prior to his death, the potential depreciation recapture is to be passed through to the beneficiary who receives the property.

Adjustment for "fresh start."—Under the Act, the adjusted basis of property which the decedent is treated as holding on December 31, 1976, is increased, for purposes of determining gain (but not loss), by the amount by which the fair market value of property on December 31, 1976, exceeds its adjusted basis on that date. In essence, this modification continues existing law with respect to appreciation in property accruing before January 1, 1977, and provides everyone with a "fresh start."

The "fresh start" rule is applicable to any property held by the decedent which reflects the basis of that property on December 31, 1976. The rule also applies to the surviving spouse's share of community property which was held on that date. Property held by the decedent at his death which he acquired in a nontaxable exchange with other property which the decedent held on December 31, 1976, is eligible for the "fresh start" provision. Likewise, property acquired by the decedent as a gift or from a trust qualifiies for the "fresh start" treatment if the donor or trustee held the property on December 31, 1976, even though the decedent acquired the property by gift or by distribution from the trust (with a carryover basis) after December 31, 1976. Similarly, property which the decedent held on December 31, 1976, that he gave to another within 3 years of his death qualifies for the "fresh start" treatment when such property is includible in the gross estate of the decedent (if the property was not sold by the transferee before the decedent's death). The Treasury Department is to issue regulations providing rules where the decedent has property which reflects the basis of property held on December 31, 1976, where the decedent has made capital improvements or other additions to the property. The "fresh start" adjustment is made only once with respect to property, e.g., only one adjustment is permitted where property passes through two or more estates after 1976.

In order to avoid the necessity of obtaining an appraisal on all property held on December 31, 1976, the Act contains a provision which requires that all property, other than securities for which market quotations are readily available, is to be valued under a special valuation method. The special rule is to be used where the carryover basis property whose basis does not reflect the basis of property which, on December 31, 1976, was a marketable bond or security. In general, the special rule determines the adjustment by assuming that any appreciation occurring since the acquisition of the property until the date of the decedent's death occurred at the same rate over the entire time that the decedent is treated as holding the property.

Under the special rule, the amount of the increase in basis is equal to the sum of (1) the amount of all depreciation, amortization, or depletion allowed or allowable with respect to the property during the period the decedent is treated as holding the property prior to January 1, 1977, and (2) the portion of the appreciation on the asset since its purchase that is assumed to have occurred during the period that the decedent is treated as holding the property prior to January 1, 1977.

The appreciation treated as occurring before December 31, 1976, is determined by multiplying the total amount of appreciation over the entire period during which the decedent is treated as holding the property by a ratio. The ratio is determined by dividing the number of days that the property is considered to be held by the decedent before January 1, 1977, by the total number of days that the property is considered to be held by the decedent.

The total amount of appreciation is computed by subtracting from the fair market value of the property on the date of the decedent's death a recomputed basis, which is basically equal to the purchase cost of the property. For purposes of this rule, the fair market value of property on the date of the decedent's death is to be determined under the special valuation rule for farms or other closely held businesses if that rule is elected for estate tax purposes (sec. 2032A), but determined without regard to the alternate valuation rule (sec. 2032).

The special valuation method must be used for all property other than marketable bonds or securities. Thus, the special valuation method must be used even though the executor or beneficiary of the decedent can establish the fair market value of the property on December 31, 1976, is other than the value determined under the special valuation method.

Where the decedent (or his predecessor) made a substantial improvement to any property, the Treasury Department is to issue regulations under which that substantial improvement is treated as a separate property for purposes of this special rule.

Under the Act, the December 31, 1976, value of marketable bonds or securities must be determined by their market value on December 31, 1976. Marketable bonds or securities are securities which are listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign national or regional exchange; securities regularly traded in the national or regional over-the-counter market, for which published quotations are available; securities locally traded for which quotations can readily be obtained from established brokerage firms; and units in a common trust fund. The value of such securities is to be determined using the normal methods of valuation for estate and gift tax purposes.

Where the "fresh start" rule applies, the amount of the increase in basis that is permitted under the "fresh start" rule is not to be reduced even though the property is subject to depreciation, depletion, etc. The Treasury Department is to issue regulations determining the application of the "fresh start" rule where gain from the sale of the property is subject to special rules taxing all or a portion of the gain as ordinary income (sec. 306, 1245, 1250, etc.) and where the property is held by a trust or partnership in which the decedent was a beneficiary or a partner.

Any increase in basis permitted by the "fresh start" rule is made before any other adjustments are made to the property's basis for Federal and State death taxes and minimum basis.

Adjustment for Federal and State estate taxes.—As indicated, the Act increases the basis of carryover basis property by a portion of the Federal and State estate taxes attributable to the carryover basis property. The purpose of the adjustment for Federal and State estate taxes is to prevent a portion of the appreciation from being subject to both the estate tax and the income tax. For this reason, the adjustment is limited to the portion of the Federal and State estate taxes that is attributable to the appreciation in the carryover basis assets. That portion for each individual carryover basis asset is determined by multiplying the net Federal and State estate tax after all credits by a fraction. The numerator of the fraction is the amount of appreciation in the individual carryover basis asset and the denominator is the total value of all property of the decedent subject to the estate tax.

In order to assure that the portion of the appreciation on each particular asset is not also subject to income tax, the appreciation on each asset is not to be reduced by any depreciation or loss in value of any other carryover basis property. In other words, the appreciation is determined on an asset by asset basis; there is no "netting" to determine unrealized appreciation for the estate as a whole. If it were not for this rule, heirs receiving appreciated property might be unfairly disadvantaged *vis a vis* other heirs.

The term "Federal and State estate taxes" includes the tax imposed by section 2001 or 2101 reduced by any credits allowable against such tax. It does not include any additional estate tax imposed because of a disposition of property which qualified for the special farm or closely held business valuation method. However, the tax imposed on expatriated residents or citizens (sec. 2107) is to be treated as the basic estate tax imposed (sec. 2001).

Also included in the definition of "Federal and State estate taxes" are any estate, inheritance, legacy, or succession taxes imposed by a State or the District of Columbia, for which the estate is liable under local law or the applicable instrument and which are actually paid by the estate to the State or the District of Columbia. If the taxes are paid by someone other than the estate, then the taxes do not come wihin the definition of "Federal and State estate taxes." (Nonetheless, an adjustment to basis may be permitted—see discussions below.)

The adjustment to carryover basis provided under the Act is made only with respect to property which is "subject to tax" for Federal estate tax purposes. For this purpose, the Act contains a special rule with respect to Federal and State estate taxes which provides that property for which a charitable or marital deduction is allowed (sections 2055, 2106 or section 2056) is not considered to be "subject to tax." It is the intent of the Congress that the Treasury Department will issue regulations providing rules for determining where property that is bequeathed to charity or the decedent's surviving spouse is not "subject to tax" because it qualifies for the charitable and marital deduction.

However, it is expected that such regulations will provide that only property that is actually used to fund the charitable or marital bequest will be deemed to be not "subject to tax." For example, assume that the decedent make bequests of specific property to his children and then leaves the residue of his estate to his surviving spouse. Property in the residue that is used to pay administration expenses, and estate taxes does not qualify for the marital deduction and, consequently, such property is "subject to tax" under this rule even though the property was originally part of the residue.[3]

In addition, a surviving spouse's share of community property is not considered to be "subject to tax" since it is not included in the deceased spouse's gross estate. Thus, no adjustment is to be made to the basis of the surviving spouse's share of community property.

As a rule of administrative convenience, property qualifying for the exclusion for transfers to orphans provided in the Act is treated as property which is "subject to tax."

Under the estate tax law, property which "is subject" to a mortgage for which the estate is not liable (i.e., a nonrecourse debt) may be included in the gross estate at its net value, that is, its fair market value less the amount of the mortgage.

However, it is possible that the executor may include the full value of the property in the gross estate and claim a deduction for the liability even though the estate is not liable for that mortgage. In order to assure that all properties which are subject to nonrecourse mortgages are treated uniformly, the Act contains a rule that provides that only the net value of the property subject to a nonrecourse mortgage is considered to be "subject to tax" regardless of how that property is treated in the estate tax return.

For example, assume that the decedent's gross estate included real estate which was worth $100,000 with a basis of $10,000, but which was subject to a nonrecourse mortgage of $80,000. Under the Act, the fair market value of the real estate for purposes of increasing the basis of the property by Federal and State estate taxes is only $20,000. This is the amount which created additional estate taxes and, consequently, only the estate tax attributable to the appreciation in that amount should be allocated to that asset. Since the basis of that property is $10,000, there is net appreciation of $10,000.[4] Consequently, the Federal and State estate taxes attributable to the $10,000 of net appreciation is added to the basis of the real estate.

Minimum basis.—As indicated above, the Act provides that the aggregate bases of all carryover basis property may be increased (but not above fair market value) to a minimum of $60,000. For this purpose, the determination of whether the aggregate bases of all carryover basis property exceeds $60,000 is to be determined after the increase in basis for "fresh start" and for Federal and State estate

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[3] Moreover, where property is used to fund the charitable or marital bequest, but a deduction is allowed with respect to only a portion of that property, only a portion of the property used to fund those bequests will be treated as "subject to tax." For example, assume the decedent specifically bequeathes his wife $400,000 worth of stock (with a basis of $100,000) but only $250,000 of the value qualifies for the marital deduction. In such a case stock with a value of $150,000 will be treated as subject to tax and, consequently, only the Federal and State estate tax attributable to the appreciation on the portion of the stock subject to tax ($150,000 minus the allocable portion of the basis of $37,500 or $112,500) can be added to the basis of all of the stock passing to the surviving spouse.

Likewise, where the decedent leaves property to a charitable remainder trust with a fair market value of $400,000 and a basis of $100,000 and the charitable portion of the trust is actuarily computed to be 40 percent, the amount subject to tax will be $240,000 (60 percent of $400,000). Consequently, only the portion of the Federal estate tax attributable to the appreciation on the portion of the stock subject to tax ($240,000 minus the allocable portion of the basis of $60,000 or $180,000) can be added to the basis of all of the carryover basis property transferred to the charitable remainder trust.

[4] If the adjusted basis to the decedent had been greater than $20,000, no adjustment to carryover basis of that asset would be permitted.

taxes (discussed above), but before the increase in basis for State succession taxes (discussed below). Thus, if the aggregate bases of all carryover basis property in the hands of the decedent was $55,000, and the increase in basis for "fresh start" or Federal and State estate taxes is $5,000 or more, no additional adjustments are permitted under the minimum basis rule.

Once it is determined that the aggregate bases of all carryover basis property is less than $60,000, the difference between that aggregate amount and the $60,000 is then allocated among all appreciated carryover basis property on the basis of the ratio of net appreciation of each appreciated carryover basis asset [5] to total appreciation of all appreciated carryover basis property.

For purposes of determining the aggregate bases of all carryover basis property, the Act limits the bases of personal and household effects to the lesser of their adjusted bases or their fair market value at the date of the decedent's death. Often it is extremely difficult to determine the actual bases of these items, but such items typically depreciate in value from their purchase cost. Consequently, under this rule, the executor is relieved of the burden of proving the actual amount of basis of the personal or household effects if he can show that such effects have depreciated since they were purchased.

The only property which is taken into account in meeting the $60,000 limitation is property which is covered by the carryover basis rules (including cash). Thus, items not counted towards the $60,000 limit include personal and household effects up to a value of $10,000, as designated by the executor, and life insurance.

The minimum $60,000 basis rule does not apply to carryover basis property acquired from or passing from a decedent who at his death was a nonresident alien.

Adjustment in basis attributable to State succession taxes.—After the adjustments to carryover basis have been made for Federal and State estate taxes and minimum basis, the carryover basis (as adjusted) may be further increased for the portion of any State succession taxes paid by the recipient of the property which is attributable to the net appreciation on that property. The taxes which qualify for this adjustment are the amount of estate, inheritance, legacy, or succession taxes paid by the recipient of property with respect to that property to any State or the District of Columbia for which the estate of the decedent is not liable.

The adjustment for State succession taxes can only be made to property which is "subject to tax." For example, if the State tax laws contain a provision exempting certain bequests to orphans from that State's death taxes, no portion of the death taxes payable to that State can be used to increase the basis of the property that qualifies for that orphan's exclusion. Moreover, because the computation is made on the basis of the taxes paid by each recipient, taxes paid by other recipients of property from the decedent are not relevant for this adjustment.

The portion of the State succession taxes which is attributable to

[5] While none of the minimum basis adjustment is allocated to depreciated assets, the basis of the depreciated assets is nonetheless counted toward meeting the $60,000 limitation. In addition, the rule discussed above relating to the fair market value of property subject to a mortgage is applicable for the purpose of determining whether there is appreciation in that property under this subsection.

the net appreciation in the property received by that person is computed by multiplying the total amount of the succession taxes paid by that person by a fraction, the numerator of which is the net appreciation in that particular property and the denominator of which is the fair market value of all property acquired by that person which is subject to the succession taxes. For this purpose, the mortgage rule discussed above is also applicable to this computation where it is relevant.

Example illustrating application of adjustments to carryover basis rules.—For purposes of computing gain, the application of the rules which increase the basis of carryover basis property can be illustrated by the following example. Assume that the decedent dies in 1977 with personal effects with a fair market value of $10,000 and an adjusted basis of $50,000 and marketable stock with fair market value of $390,000 and a basis of $25,000. His will leaves his entire estate to his surviving spouse. The value of the stock on December 31, 1976, was $39,000. If it is assumed that there are no funeral or administration expenses, there will be a gross estate of $400,000, a marital deduction of $250,000, and a taxable estate of $150,000. In this case, there is a basic tax of $38,800 less a credit of $30,000 leaving an estate tax of $8,800.

Assume in this example that the State death taxes paid by the widow are equal to the maximum State death tax credit and that the entire amount is subject to tax. Since the taxable estate in this case is $150,000, the "adjusted taxable estate" will be $90,000. Consequently, the maximum amount of the State death tax credit is $400 and the net estate tax is $8,400.

Assume that the executor makes the election to exclude all of the personal assets from carryover basis property. Thus, the basis of the personal assets is their fair market value as under existing law. In addition the basis of the stock under the "fresh start" rule is initially increased to $39,000.

Because of the marital deduction, $250,000 of the $400,000 of gross estate is deemed to be not subject to tax. Of the remaining $150,000, $3,500 ($10,000 multiplied by $150,000 divided by $400,000) is deemed to be personal effects. Thus, the portion of the carryover basis property (i.e., the stock) which is subject to tax is $146,250 ($150,000 minus $3,750). The adjusted basis of that carryover basis property is $14,625 ($146,250 multiplied by $39,000 divided by $390,000). Consequently, the amount of appreciation in the carryover basis property is $131,625 ($146,250 minus $14,625). Thus, the basis of all carryover basis property is increased by $7,371 ($131,625 multiplied by $8,400 divided by $150,000) to $46,371 ($39,000 plus $7,371).

The basis of all carryover basis property is then increased to a minimum basis of $60,000. Since the personal effects are not considered carryover basis property by reason of the executor's election, the basis of these assets does not count toward the minimum basis of $60,000. As a result, the basis of the stock is increased by $13,629 to $60,000.

Finally, the basis is further increased by any State inheritance or estate taxes paid by the recipient with respect to the appreciation on the carryover basis property. After the other adjustments permitted under the Act, the appreciation in the carryover basis property is $330,000 ($390,000 less $60,000). The portion of the State death tax allocable to the appreciation in the carryover basis property is $330 ($330,000 multiplied by $400 divided by $400,000). Consequently, the basis of the carryover basis property is increased from $60,000 to $60,330.

Other technical amendments

(*1*) *Amendments to section 691.*—The Act makes two amendments to section 691 (relating to income in respect of a decedent) in order to more nearly equate the treatment of items of income in respect of a decedent with the treatment given to carryover basis property. Under prior law, the recipient of income in respect of a decedent was permitted a deduction only with respect to Federal estate taxes which were attributable to the income in respect of a decedent. The Act broadens the types of taxes for which a deduction is allowed to all Federal and State estate taxes (as defined in section 1023(f)(3)).

Second, under prior law, the amount of Federal estate taxes for which a deduction was allowed (section 691(c)) was determined by comparing what the actual Federal estate taxes were with what they would have been if the income in respect of a decedent were not included in the gross estate. The net effect of this computation was that the deduction for Federal estate taxes was determined by reference to the estate's highest estate tax brackets. However, the adjustments to carryover basis property for Federal and State estate taxes are determined on the basis of the ratio that the appreciation bears to the total fair market value of the property included in the decedent's gross estate. The net effect of this computation is that the Federal and State estate taxes are computed on an average estate tax rate. In order to more nearly equate the treatment of income in respect of a decedent with the treatment of carryover basis property, the Act provides that the deduction for Federal and State estate taxes attributable to income in respect of a decedent is computed by multiplying the amount of those taxes by a fraction, the numerator of which is the net amount of income in respect of a decedent and the denominator of which is the value of the gross estate. The effect of this amendment is to compute the deduction for Federal and State estate taxes attributable to income in respect of a decedent on the basis of the average estate tax rate on the decedent's estate.

(*2*) *Amendment to section 1015.*—The basis of property acquired by gift generally is the basis of the property in the hands of the donor plus any gift taxes paid on the gift. The purpose of the increase in basis for gift taxes paid in the gift is to prevent a portion of the appreciation in the gift (equal to the gift tax imposed on the appreciation) from also being subject to income tax, that is, to prevent the imposition of a tax on a tax. However, the Congress believed that prior law was too generous in that it permitted the basis of the gift property to be increased by the full amount of the gift tax paid on the gift and not just the gift tax attributable to the appreciation at the time of the gift. Consequently, the Act provides that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift.

(3) *Repeal of existing sections 1014(d) and 1246(e).*—Under prior law (sections 1014(d) and 1246(e)), the basis of stock of a domestic international sales corporation (DISC) and a foreign investment company was decreased by the amount of certain items of ordinary income deferred in the corporation. Since stock in such organizations will be carryover basis property, except where the basis of the stock in such organizations is increased by the adjustments to carryover basis, the repeal of these sections will result in the same taxation to the recipient of the stock as it would have had to the decedent. Therefore, these provisions are repealed by the Act.

Use of appreciated carryover basis property to satisfy pecuniary bequest.—Under present law, the distribution of property by an estate or trust in satisfaction of a right to receive a specific dollar amount is treated as a taxable transaction resulting in the recognition of gain or loss to the estate or trust.[6] However, under prior law, where the property received by the estate or trust was acquired from or passed from a decedent, the trust or estate was given a "stepped-up" basis and, consequently, the trust or estate recognized only the appreciation accruing from the date of the decedent's death to the date of distribution by the estate or trust.

The Code (sec. 2056) allows, in computing the taxable estate of a decedent, a deduction for amounts passing from the decedent to his surviving spouse. However, the maximum marital deduction allowed is limited to 50 percent of the decedent's adjusted gross estate or, if greater, $250,000 under the Act. In order to assure that the decedent leaves his surviving spouse property just sufficient to meet the maximum marital deduction, the wills of many decedents make bequests to the surviving spouse determined under a formula. There are two basic types of formulas in common use. In the first type, known as the "fractional share formula", the surviving spouse is given a fraction of each asset in the estate of the decedent. Where the trust distributes such share to the surviving spouse, there is no taxable transaction. Consequently, the change from a stepped-up basis to carryover basis does not result in additional income tax at the time of distribution.

In the second type of formula, known as a "pecuniary bequest formula", the surviving spouse is given an amount equal to a percentage of the decedent's estate. Where the trust or estate distributes property in satisfaction of this right to receive that specified dollar amount, there is a taxable transaction resulting in recognizable gain or loss. Consequently, in such a case, there is a substantial difference in income tax consequences upon distribution between the basis rules of existing law and the carryover basis rule provided by the Act. A similar problem can arise on the transfer of property to a charity in satisfaction of a bequest of a fixed dollar amount to that charity.

The Act conforms the treatment of the two types of bequests by treating the distribution by an estate in satisfaction of a pecuniary bequest as a nontaxable transaction except to the extent of the appreciation occurring from the date of the decedent's death to the date of dis-

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[6] Treas. Reg. Sec. 1.661(a)-2(f) of the regulations.

tribution. However, any loss occurring between those two dates would not be recognized. Where this section applies, the basis of the property to the distributee is the carryover basis of the property increased by the amount of any gain recognized on the distribution. Thus, under the rule provided by the Act, bequests using the "pecuniary bequest formula" will receive substantially the same income tax treatment to the estate upon distribution as under prior law.

The Treasury Department is to issue regulations applying this nonrecognition treatment to situations where a trust distributes property in satisfaction of a right to receive a specific dollar amount which is the equivalent of a pecuniary bequest. This can occur where an inter vivos trust is used as a will substitute such that the property is never held by the decedent's estate.

Procedural aspects of carryover basis

(*1*) *Decedent's basis unknown.*—In some cases, it will be extremely difficult, if not impossible, for the executor to determine the basis of some of the property owned by the decedent. Consequently, the Act contains a provision which permits the executor and the Internal Revenue Service to assume that the purchase cost of the property to the decedent (or last purchaser, where relevant) is the fair market value of the property on the date that it was purchased. In essence, this provision permits the executor and the Service to assume that the decedent (or other relevant person who last purchased the property) paid fair market value for the property at the time of purchase.

(*2*) *Information required to be furnished by executor.*—In order for the Service and the recipients of property from a decedent to know the carryover basis of that property, the Act adds a provision which requires the executor to provide such information concerning carryover basis property to the Service as may be required by regulations. Failure to provide this information by the executor results in the imposition of a penalty on the executor equal to $100 for each failure with a maximum amount for all such failures equal to $5,000. It is expected that the Service will establish a procedure under which the executor will be deemed to have met this reporting requirement if the executor has done everything reasonable to obtain the information, but is still unable to do so.

In addition, the provision requires the executor to provide to each recipient of property from a decedent the adjusted basis of that property with the adjustments provided for Federal and State estate taxes and minimum basis, but before adjustment for State succession taxes. Failure to provide this information will result in the imposition of a penalty on the executor of $50 for each such failure (unless such failure is due to reasonable cause) with a maximum amount for all such failures of $2,500.

Effective date

Generally, the amendments are effective for decedents dying after December 31, 1976. In the case of the amendment relating to adjustment to basis for gift taxes paid, the amendment is effective for gifts made after December 31, 1976.

6. Generation-Skipping Transfers (sec. 2006 of the Act and secs. 2601, 2602, 2603, 2611, 2612, 2613, 2614, 2621, and 2622 of the Code)

Prior law

Under the tax law, a Federal gift or estate tax is generally imposed upon the transfer of property by gift or by reason of death. However, under prior law, the termination of an interest of a beneficiary (who is not the grantor) in a trust, life estate, or similar arrangement was not a taxable event unless the beneficiary under the trust had a general power of appointment with respect to the trust property.

This result (nontaxability) occurred even when the beneficiary under the trust had: (1) the right to receive the income from the trust; (2) the power to invade the principal of the trust, if this power was subject to an ascertainable standard relating to health, education, support, or maintenance; (3) a power (in each beneficiary) to draw down annually from his share of the principal the greater of 5 percent of its value or $5,000; (4) a power, exercisable during life or by will, to appoint any or all of his share of the principal to anyone other than himself, his creditors, his estate or the creditors of his estate; or (5) the right to manage the trust property by serving as trustee.

Most States have a rule against perpetuities which limits the duration of a trust. While the rules of the different States are not completely uniform, in general such laws require that the ownership of property held in trust must vest in the beneficiaries not later than the period of the lifetime of any "life in being" on the date of the transfer, plus 21 years (and 9 months) thereafter.

Reasons for change

The purpose of the Federal estate and gift taxes is not only to raise revenue, but also to do so in a manner which has as nearly as possible a uniform effect, generation by generation. These policies of revenue raising and equal treatment are best served where the transfer taxes (estate and gift) are imposed, on the average, at reasonably uniform intervals. Likewise, these policies are frustrated where the imposition of transfer taxes is deferred for very long intervals, as was possible, under prior law, through the use of generation-skipping trusts.

Prior law imposed transfer taxes every generation in the case of families where property passed directly from parent to child and then from child to grandchild. However, where a generation-skipping trust was used, no tax was imposed upon the death of the child even where the child had an income interest in the trust, and substantial powers with respect to the use, management, and disposition of the trust assets. While the tax advantages of generation-skipping trusts were theoretically available to all, in actual practice these devices were more valuable (in terms of tax savings) to wealthier families. Thus, generation-skipping trusts were used more often by the wealthy.

Generation skipping resulted in inequities in the case of transfer taxes by enabling some families to pay these taxes only once every several generations, whereas most families must pay these taxes every generation. Generation skipping also reduced the progressive effect of the transfer taxes, since families with moderate levels of accumulated wealth might pay as much or more in cumulative transfer taxes as wealthier families who utilized generation-skipping devices.

The Congress recognized that there are many legitimate nontax purposes for establishing trusts. However, it also believed that the tax laws should basically be neutral and that there should be no tax advantage available in setting up trusts. Consequently, the Act provides generally that property passing from one generation to successive generations in trust form is to be treated, for estate tax purposes, substantially the same as property which is transferred outright from one generation to a successive generation. The Act does provide one limited exception to this general rule, however, to cover the case where a trust is established for the benefit of the grantor's grandchildren.

Explanation of provisions

Overview.—Under the Act,[1] a new chapter 13 is added to the Internal Revenue Code, which imposes a tax in the case of generation-skipping transfers under a trust or similar arrangement[2] upon the distribution of the trust assets to a generation-skipping heir (for example, a great-grandchild of the transferor) or upon the termination of an intervening interest in the trust (for example, the termination of an interest held by the transferor's grandchild).

Basically, a generation-skipping trust is one which provides for a splitting of the benefits between two or more generations which are younger than the generation of the grantor of the trust. The generation-skipping tax would not be imposed in the case of outright transfers. In addition, the tax would not be imposed if the grandchild had (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor.

The tax is to be substantially equivalent to the tax which would have been imposed if the property had been actually transferred outright to each successive generation. For example, where a trust is created for the benefit of the grantor's grandchild, with remainder to the great-grandchild, then, upon the death of the grandchild, the tax is to be computed by adding the grandchild's portion of the trust assets to the grandchild's estate and computing the tax at the grandchild's marginal transfer tax rate. In other words, for purposes of determining the amount of the tax, the grandchild would be treated under the Act as "deemed transferor" of the trust property.

The grandchild's marginal estate tax rate would be used as a measuring rod for purposes of determining the tax imposed on the generation-skipping transfer, but the grandchild's estate would not be liable for the payment of the tax. Instead, the tax would generally be paid out of the proceeds of the trust property. However, the trust would be entitled to any unused portion of the grandchild's unified transfer tax credit, the credit for tax on prior transfers, the charitable

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[1] The provisions in the Act concerning generation skipping are the same, in many respects, as the provisions of H.R. 14844, which was reported by the Ways and Means Committee (House Report 94-1380) but was not considered on the Floor of the House due to the enactment of the Tax Reform Act.

[2] For purposes of these rules, trust equivalents include life estates, estate for years, certain insurance and annuity contracts, and other arrangements where there is a splitting of the beneficial enjoyment of assets between generations.

deduction (if part of the trust property were left to charity), the credit for State death taxes and a deduction for certain administrative expenses. In addition, the value of the grandchild's gross estate will be increased by the generation-skipping transfer for marital deduction purposes.

These rules are discussed in more detail below.

Generation-skipping trust.—A generation-skipping trust is a trust having two or more generations of "beneficiaries" who belong to generations which are "younger" than the generation of the grantor of the trust. For purposes of the generation-skipping provisions, a "grantor" of the trust would include any person contributing or adding property to the trust. (Regulations are to provide for cases where a trust has more than one grantor.)

Generally, a generation would be determined along family lines where possible. For example, the grantor, his wife, and his brothers and sisters would be one generation; their children (including adopted children) would be the first "younger generation," the grandchildren would constitute the second "younger generation," etc. Husbands and wives of family members would be assigned to the same generation as his or her spouse.

Where generation-skipping transfers are made outside the family, generations are to be measured from the grantor. Individuals not more than 12½ years younger than the grantor would be treated as members of his generation; individuals more than 12½ years younger than the grantor, but not more than 37½ years younger, would be considered members of his children's generation, etc.

Beneficiary; power; interest.—For purposes of these rules, a person is a "beneficiary" if he has either a present or future "interest" or "power" in the trust.

An interest includes the right to receive income or corpus from the trust during the duration of the trust, or the right to receive a distribution upon its termination. Also, a person has an interest in a trust if he is a permissible recipient of income or corpus under a power exercisable by himself or another. For example, if a trust provided that the income was to be paid for life to the grantor's child, then to the grantor's grandchild, with the corpus to be distributed to the great grandchildren, then the child, grandchild, and great grandchildren would all be beneficiaries under the trust (because all three generations would have had a present or future right to receive income or corpus) and the trust would be a generation-skipping trust (because there are two or more generations of younger generation beneficiaries). During the life of the child, only the child would be deemed to have a present interest in the trust.

Likewise, if a trust were created which provided that a trustee was to have discretionary power to distribute the income from the trust among the grantor's three children, A, B, and C, with the remainder to be distributed, in the trustee's discretion, to the grantor's grandchildren, then the three children and the grandchildren of the grantor would be "beneficiaries" under the trust because each child and grandchild would be a "permissible" recipient of income or corpus under the trust. Thus, the trust would be a generation-skipping trust [3] and each permissible recipient would be deemed to have a present interest in the trust.

On the other hand, a trust which provided that the income was to be paid for life to the grantor's spouse, with remainder to the grantor's grandchild, would not be a generation-skipping trust because there would not be two or more generations of beneficiaries which were "younger" than that of the grantor. If the trust provided that the income was to be paid for life to the grantor's spouse, with remainder to the grantor's issue who survived the spouse, per stirpes, and during the spouse's life there were children and grandchildren of the grantor living, the trust would be a generation-skipping trust. However, no generation-skipping transfer would result from the death of the spouse. In addition, corpus distributions to the grandchildren during the spouse's life would not be treated as taxable distributions if the children did not have a present interest or power in the trust.

Under the Act, a person having a "power" with respect to a trust is also to be treated as a beneficiary. For purposes of these rules, the term "power" means any power to establish or alter beneficial enjoyment of the corpus or income of the trust. This term does not include a mere right of management with respect to the trust property. For example, if a trust provided that the income was to be paid to the grantor's great grandchild, with the corpus to be distributed to that great grandchild when he attained age 35, the trust would not be treated as a generation-skipping trust, even if a child or grandchild of the grantor served as trustee, because the trustee would not have the right to establish or alter beneficial enjoyment of the income or corpus of the trust.

On the other hand, a limited power of appointment generally would be treated as a "power" for purposes of these rules, subject to one exception. If the power is currently exercisable, it is a present power. However, if the power is exercisable only by will, it is a future power until the death of the holder of the power. Under the exception, an individual would not be treated as holding a "power" (and, therefore, would not be treated as a beneficiary) for purposes of these rules, if his sole discretion under the power is the right to allocate income or corpus of the trust among lineal descendants of the grantor who belong to a generation (or generations) younger than that of the individual holding this right of allocation. For example, a trust for the benefit of the grantor's grandchildren would not be treated as a generation-skipping trust merely because their father or uncle had the right to allocate income or corpus among them.

A power to draw down annually from the principal of the trust the greater of 5 percent of its value or $5,000, as well as the power to invade principal subject to an ascertainable standard relating to health, education, support or maintenance, are both to be treated as present powers for purposes of these rules (unless the power were exercisable by an individual for the benefit of lineal descendants of the grantor under the exception just described).

This trust might or might not be taxable, however, because the committee bill permits a limited generation skip on a tax-free basis where the generation-skipping transfer is made to the grantor's grandchildren (see discussion below).

In any event, the individuals on whose behalf such powers were exercisable would generally be beneficiaries under the trust since they would have a present "interest" in the trust as permissible recipients of income or corpus.

Generation-skipping transfer.—As indicated above, under the Act, a tax is to be imposed in the case of a "generation-skipping transfer." This term is defined to mean either a "taxable termination" or a "taxable distribution."

Termination.—A taxable termination means the termination of an interest or power of a younger generation beneficiary who is a member of a generation which is older than that of any other younger generation beneficiary. Such a termination would generally occur by reason of death (in the case of a life interest) or by lapse of time (in a case where the grantor created an estate for years).

For example, if a trust provided income for life to the grantor's child, with remainder to the grantor's great grandchild, there would be a taxable termination of the child's interest upon his death because this death would terminate the interest (in this case, a life income interest) of a younger generation beneficiary (the child) who was a member of a generation older than that of any other younger generation beneficiary (the great grandchild) under the trust. For purposes of determining whether there has been a generation-skipping transfer, the determination as to whether there are younger generation beneficiaries is to be made immediately before the transfer takes place.[4]

However, under the Act, a taxable termination does not occur where the only interest or power which is terminated is a future interest or power. This is to prevent a situation where a tax might be imposed in a case where the beneficiary under the trust never has a present interest or power. For example, if a trust provided income to the child for life, then to the grandchild for life, with remainder to the great grandchild, and the grandchild was the first to die, there would not be a taxable termination because the grandchild never held a present income interest in the trust.

In certain cases, two or more members of the same generation may be beneficiaries who have present interests under the same trust. The Act provides that generally, in such cases (except as provided in regulations), the taxable termination with respect to each such beneficiary is to be treated as having occurred at the time the last termination occurs with respect to that generation.

For example, assume that the grantor creates a trust providing that the trustee, in his discretion, is to distribute the income for the benefit of the grantor's three children, A, B, and C, during their lives, and is to distribute the corpus of the trust to his great grandchildren upon the cessation of the life income interests. No tax would be imposed upon the death of A and B; upon the death of C, however, there would

[4] For example, assume that a trust provides income for life to the grantor's child, then income to charity for 10 years, with remainder to the great grandchild. The death of the child would constitute a taxable termination because, immediately prior to that event, there were two generations of younger generation beneficiaries having an interest in the trust.

be a taxable termination with respect to the trust and the tax base (i.e., the trust assets) would be valued at that time.[5]

Also, in the case of a trust under which corpus distributions are discretionary (or sprinkling trust), the tax is postponed because it is difficult to value the terminated interest until all members of the intervening generation have terminated their interests (i.e., the grantor's children might receive all of the corpus from the trust, or none of it).

Under the Act, postponement of tax would also occur where members of several different generations have a present interest or power in the same trust. Under these circumstances, if the interest of the member (or members) of the younger generation terminate first (because of an unusual order of death or for some other reason), tax is to be postponed until the interest of the older generation also terminates. For example, assume that a discretionary trust is created providing the income for life to the grantor's spouse and his two children, A and B, with the remainder to be distributed to their grandchildren. Under the Act, if A and B both predecease the spouse, no taxable termination would occur until the death of the spouse at which time a taxable termination would occur. (A and B would be the deemed transferors, and the tax base would be determined at the time of the taxable termination, i.e., the death of the spouse.)

These rules concerning postponed terminations apply where two or more persons hold present interests or powers in the trust simultaneously, and also apply where a beneficiary who is a member of the same (or a higher) generation as the beneficiary whose interest has terminated holds a present interest or power in the trust immediately after the termination. For example, assume that the trust provides income for life to the grantor's nephew, subject to a limited power of appointment exercisable by the nephew upon his death, with the principal to be distributed to the nephew's issue. If the nephew exercises the power by providing that the trust income is to be paid to his wife for life before the distribution of principal to his issue, tax is postponed until the death of the wife. (Of course, only one tax is imposed at that time; the nephew is the deemed transferor, and the tax base is computed as of the date of the death of the nephew's spouse.)

In certain cases, the rule under the Act may cause several taxable terminations to occur at the same time. For example, assume a trust is created for the benefit of the grantor's nephew and his nephew's son for life, with the remainder to be distributed to the nephew's grandson. If the nephew's son dies before the nephew, no tax would be imposed at that time; upon the death of the nephew, however, a tax would be imposed on the termination of the nephew's interest. The amount of this tax would then be deducted from the tax base (the value of the trust assets) and the tax which had been postponed upon the death of the nephew's son would then be imposed. (The reason for deducting the tax imposed on the termination of the nephew's interest is to avoid a double tax; the net result under the Act is that the generation-skipping

[5] This is not to suggest that all tax consequences would be computed by reference to C's estate; generally C would be the "deemed transferor" only with respect to the amount passing to his grandchildren (A and B would be deemed transferors of amounts passing to their grandchildren) (see discussion below).

tax will be essentially the same, even where there is an unusual order of death.)

However, the Congress intended that the Treasury Department is to have authority to prescribe regulations covering cases where the rules just outlined are utilized primarily for the postponement of tax. For example, if the trust provided income for life to A, B and C, the grantor's children, with the income then to be paid to X, Y and Z (three unrelated members of the children's generation) or accumulated, in the discretion of the trustee, it is contemplated that the taxable termination would be treated as having occurred upon the death of the survivor of A, B and C (rather than upon the death of the survivor of A, B, C, X, Y and Z).[6]

In addition, there are certain instances where several individuals, who are nominally beneficiaries under the same trust, actually have interests which are identifiable and separate from those of other beneficiaries. Under the Act, these interests are to be treated as interests in separate trusts in accordance with "separate share" rules to be prescribed in regulations.

For example, assume that the grantor establishes a trust for the benefit of his two children, A and B. Under the terms of the trust, 50 percent of the income must be allocated to each of the two children and, upon the death of either child, 50 percent of the corpus of the trust is to be distributed to that child's grandchildren. Under these circumstances, the separate share rules would apply, and there would be a taxable termination upon the death of either A or B with respect to that child's share of the trust.

It is expected that the regulations concerning the separate share rule will, to the extent practicable, prescribe rules which are substantially similar to those which apply presently to the income taxation of trusts (under Subchapter J).

In a case where a beneficiary has more than one interest or power in a trust then, except as provided in regulations,[7] the taxable termination with respect to all of these interests or powers is to be treated as having occurred at the time of the termination of the last such interest or power. For example, if an individual has a life income interest in the trust, as well as a power to draw down the greater of 5 percent of his share of the trust principal or $5,000 each year over a limited period of time, the taxable termination would occur at the expiration of the life interest. In general, future interests and powers will be disregarded in determining whether a taxable termination has occurred.

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[6] Where there was a mandatory payout of all of the income to X, Y, and Z, however, the regulations might provide that the taxable termination would occur upon the death of the survivor of this group of 6.

[7] It was anticipated that the regulations will provide special rules for cases involving nominal or contingent interests. For example, if an individual had a right to all of the income from a trust for a 20-year period, followed by the right to receive $1 a year for life, the taxable termination of the 20-year income interest would not be postponed by the existence of the nominal $1 per year interest.

Likewise, if the trust provided the grantor's child with an income interest for 20 years, with a subsequent life income interest to the grandchild and remainder to the great grandchild, with a contingent remainder to the child if grandchild and great grandchild predecease him, the existence of the contingent remainder at the expiration of the 20-year income interest would not be sufficient to postpone the "termination" of the child's income interest.

The assignment of a beneficiary's interest in a generation-skipping trust is not to be treated as a taxable termination. For example, assume a trust provided that the income was to be paid to the grantor's nephew for life, with the remainder to be distributed to the nephew's son upon his death. If the nephew assigned his life income interest (with or without receiving consideration), this would not constitute a termination of that interest for purposes of the tax on generation-skipping transfers. However, the death of the nephew would constitute a taxable termination and the tax would be imposed based upon the value of the trust at that time.

Distribution.—Under the Act, a "taxable distribution" occurs whenever there is a distribution from a generation-skipping trust, other than a distribution out of accounting income (sec. 643(b) of the Code), to a younger generation beneficiary of the trust in all cases where there is at least one other younger generation beneficiary who is a member of an older generation. For example, assume that a discretionary trust is established for the benefit of the grantor's child and great grandchild. The trustee exercises his discretion by distributing accounting income to the child and also makes a distribution out of corpus to the great grandchild. This would constitute a taxable distribution because there would be at least one younger generation beneficiary (the child) who was a member of a generation older than that of the great grandchild.[8]

The rule with respect to accounting income is primarily a rule of administrative convenience in cases where the trustee is required, or decides under discretionary powers, to distribute all or some of the trust income for a particular year or years. This rule does not apply to accumulated income. Also, to prevent this rule from being used for tax avoidance purposes, the Act provides that, where there are distributions out of corpus as well as out of income, the distributions to members of the oldest generation (whether or not they are younger generation beneficiaries) are to be treated as having been made out of income (to the extent of the income), and the distributions to younger generations are to be treated as having been made out of any remaining income, and then out of corpus.

In addition, the Congress understood that trustees are sometimes authorized to make "loans" to beneficiaries of a trust which are made from (or secured by) trust assets. A loan, particularly if it is unsecured and bears no interest (or only nominal interest), may be substantially equivalent to a distribution. The Congress intended that the Internal Revenue Service may require reporting with respect to these loan transactions and will scrutinize this type of transaction carefully to determine whether there has been a loan or a distribution.

Of course, the terms "taxable termination" and "taxable distribution" do not include any amounts which are subject to estate or gift tax (for example, because the beneficiary whose interest in a trust has terminated had a general power of appointment with respect to the trust property).

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[8] Of course, a distribution of income or corpus to the child would not be a taxable distribution. The amount of the distribution would eventually be taxable to the estate of the child, just as any amount which the child received outright from his parent, and no generation skipping would have occurred.

Under the Act, where both a termination and a distribution result from the same occurrence (such as the death of a member of an intervening generation), the transfer is to be treated as a termination.

Gifts to grandchildren.—Under the Act, the terms "taxable termination" and "taxable distribution" do not include a transfer to a grandchild of the grantor of the trust to the extent that total transfers from all terminations and distributions through a "deemed transferor" do not exceed $250,000. Under the Act, the "deemed transferor" of a grandchild of the grantor will be the grantor's child who is also the grandchildren's parent. Thus, if the grantor has two children, A and B, up to $500,000 could be transferred from the generation-skipping trust to the children of A and B ($250,000 to the children of each) without a tax being imposed upon the termination of A's or B's interest in the trust.

This $250,000 exclusion is also to apply if the transfer from a trust to a grandchild (which would result in tax but for the exclusion) were in the form of a taxable distribution rather than a taxable termination. Where there are several distributions or terminations from one or more trusts which flow through the same deemed transferor, the $250,000 exclusion is to be applied against the first of these distributions or terminations, then the second, and so forth, until the exclusion has been fully utilized.[9] (Where there are simultaneous transfers, which are triggered by the same event and flow through the same deemed transferor, and which benefit more than one grandchild of the grantor of the trust, the $250,000 exclusion is to be allocated pro rata between the simultaneous transfers, in accordance with their fair market value.)

This $250,000 exclusion is to be available in any case where the property vests in the grandchild (i.e., the property interests will be taxable in the grandchild's estate) as of the time of the termination or distribution, even where the property continues to be held in trust for the grandchild's benefit, and regardless of whether the grandchild receives his interest under the express terms of the trust, or as the result of the exercise (or lapse) of a power of appointment with respect to the trust.

Tax imposed only once each generation.—Under the Act, the tax on generation-skipping transfers is to be imposed only once each generation with respect to the same trust share or interest. To achieve this result, the Act provides that where the deemed transferor of the property which is being transferred is a member of the same generation as, or a higher generation than, any prior deemed transferor of the same property, and the transferee in the prior transfer is a member of the same generation as, or a higher generation than, the transferee of the current transfer, then the current transfer is not to be treated as a taxable termination or distribution (to the extent that the prior transfer was taxable).

For example, assume a trust is created which provides that the income for life is to go to the grantor's son, then to the grantor's great

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[9] All trusts established by a grandparent or his spouse for any child's children would be attributed to that child as deemed transferor; thus, only one $250,000 exclusion is to be allowed to flow through a child of the grantor (for the ultimate benefit of the grandchildren.

grandchild A, then to the grantor's daughter, with the remainder to be distributed to the grantor's great grandchild B. The death of the grantor's son would constitute a taxable termination. However, the death of the grantor's daughter would not constitute a taxable termination "to the extent that" [10] the value of her interest which terminated had previously been subject to tax upon the death of the son. This is because the deemed transferor (the daughter) belonged to same generation as a previous deemed transferor with respect to the property (the son), and the transferee of the property (great grandchild B) is a member of the same generation as a previous transferee (great grandchild A).[11]

Also, under the Act, these rules preventing the imposition of a second tax (where there are two or more deemed transfers of the same trust property attributable to the same generation) are not to be applied where this would have the effect of avoiding the tax with respect to any other transfer.

The tax base.—In the case of a taxable distribution, the amount subject to tax is the value of the money and property distributed (determined as of the time of the distribution). The tax base includes the transfer taxes paid under these rules with respect to the distribution, regardless of whether these taxes are paid by the beneficiary out of the proceeds of the distribution, or the taxes are paid by the trustee out of trust monies which are paid over directly to the Government.

In the case of a taxable termination, the tax base equals (1) the value of the trust property in which an interest has terminated and/or (2) the value of the property which was the subject of a power (where a power has terminated).[12]

For example, if the grantor established a trust providing income for life to his nephew, then income for life to his nephew's son, with the remainder to be distributed to his nephew's grandchildren, the tax base upon the death of the nephew would be the value of the trust assets, determined as of the date of the nephew's death or the alternate valuation date. (A similar rule would apply upon the death of the nephew's son.)

Under the Act, where a beneficiary has more than one interest or power in a generation-skipping trust, the imposition of the generation-skipping tax is generally delayed until the termination of the last power or interest of that beneficiary in the trust. For example, where an individual is entitled to receive all of the trust income until the individual dies or reaches age 35 and also has a power commencing at age 35 to withdraw 5 percent of the trust corpus for life, the generation-skipping tax will be imposed at the death of the individual and not when the individual reaches age 35.

The amount subject to tax at the death of the individual is the cumulative value (not in excess of 100 percent of the value of the trust assets

[10] Assume that, upon the death of the son, the value of the trust assets subject to tax is $100 000 and that upon the death of the daughter the value of the trust assets is $200,000. Under the Act, only $100,000 is to be subject to tax upon the death of the daughter because $100,000 of value was previously subject to a generation-skipping tax upon the death of the son.

[11] The same result would follow if the daughter had been a member of a higher generation than the son (mother, aunt, or uncle, etc.) and/or B had been a member of a same or higher generation than great grandchild A.

[12] Of course, where a beneficiary has both an interest and a power with respect to a trust, the total amount subject to tax is never to exceed the value of the trust assets, determined as of the time of the termination.

determined as of the time of the termination or the alternate valuation date) subject to these interests and powers. In this case, the individual held a full income interest in the trust until age 35, so the tax base is the value of the trust assets (determined as of the time of the taxable termination, i.e., the individual's death). If the individual had held only a power to withdraw 5 percent of the trust corpus annually (or $5,000, whichever is greater), the tax base equals the entire value of the trust corpus determined as of the date of the individual's death (i.e., the date of the taxable termination) because the entire trust was "subject to the power." (This is the result regardless of the number of years for which the power was held, exercised, or allowed to lapse and regardless of the average value of the trust during this period.) Likewise, if the individual were a beneficiary under a power to invade corpus subject to an ascertainable standard relating to his health, education, support or maintenance, the tax is to be the value of the trust corpus (determined as of the date of the termination) because the full trust is subject to the power.

Deductions, credit, etc.—Under the Act, property passing under a trust is to be entitled to many of the benefits which are available under the estate tax laws in the case of property which passes in an outright transfer (to the extent that property passing under the trust is subject to the tax on generation-skipping transfers).

For example, where the generation-skipping transfers occur at the same time as, or after, the death of the deemed transferor, the trust would be entitled to any unused portion of the unified credit which had not utilized in connection with the deemed transferor's estate. In addition, the charitable deduction is to be allowed for purposes of determining the tax on the generation-skipping transfer if part of the trust property passes to charity.

Also (where the generation-skipping transfer occurs at the same time as, or within nine months of the deemed transferor's death), the Act provides that in determining the size of the gross estate of the deemed transferor, for purposes of computing the marital deduction, the amount of any taxable termination or taxable distribution is to be taken into account. In certain cases, the result will be that the maximum allowable marital deduction will increase, the transfer tax payable with respect to the deemed transferor's estate will decrease, and the deemed transferor's marginal rate bracket will also decrease (thus reducing, indirectly, the tax that will be payable with respect to the property passing under the generation-skipping transfer). The Congress intended that any permitted increase in the amount of the marital deduction by reason of a generation-skipping transfer occurring after the death of the decedent is not to be treated as a terminable interest solely by reason of the fact that the maximum amount of the deduction is not known as of the date of the decedent's death.

The previously taxed property credit is also to be allowable where an estate tax had been imposed with respect to the creation of the trust and, within a 10-year period thereafter, the generation-skipping tax is imposed upon the death of the deemed transferor. Likewise, where the deemed transferor is deceased at the time of a generation-skipping transfer, property which is subject to the tax on generation-skipping transfers is to be treated as passing from the deemed transferor to the transferee and the generation-skipping tax is to be treated as an estate tax for purposes of the previously taxed property credit. The Act also provides that in connection with the credit for previously taxed property, the value of the property subject to the tax on generation-skipping transfers which is not taken into account for purposes of the estate tax (e.g., the excess over the actuarial value of the deemed transferor's life interest taken into account under present law) is to be taken into account for purposes of the credit allowed for the generation-skipping transfer tax.

In addition, the credit for state death and inheritance taxes is to be available to the extent that these taxes are levied with respect to the generation-skipping transfer (subject to the limitation under sec. 2011(b), applied as if all deemed transfers occurring on or after the deemed transferor's death were part of his estate).

In addition, trustee's fees, costs of administration, and other losses and expenses which are deductible (under sec. 2053 or 2054) in the case of an estate may be deducted from the amount of any taxable generation-skipping transfer to the extent that such items are paid for or sustained by the trust, are attributable to property which is included in the generation-skipping transfer, and have not previously been deducted for estate or income tax purposes.

The Act also provides that, where certain rights to income are subject to the tax on generation-skipping transfers, the income tax treatment of so-called "income in respect of a decedent" will apply to certain types of income. Thus, the recipient of this income (whether the trustee or a beneficiary of the trust) is entitled to a deduction (in computing the income tax on this income) for the generation-skipping tax in the same way as the recipient is allowed a deduction for the estate tax under present law (sec. 691(c)). Also, under the Act, where a generation-skipping transfer which is subject to tax occurs after the death of the deemed transferor, section 303 treatment is to be available. The trust and the actual estate of the deemed transferor are to be treated separately for purposes of the section 303 qualification requirements.

Computation of tax.—Under the Act, the tax would be substantially equivalent to the estate or gift tax which would have been imposed if the property had actually been transferred outright to each generation. This is achieved by adding the amount subject to tax as a result of the generation-skipping transfer to the other taxable transfers of the "deemed transferor." [13] The net effect is that the generation-skipping transfer is taxed at the marginal transfer tax rate of the deemed transferor.

For example, where a trust is created for the benefit of the grantor's child, with remainder to the grantor's great grandchild, then, upon the death of the child, the tax would be computed by adding the child's portion of the trust assets to the child's estate and computing the tax at the child's marginal estate tax rate. The child would be treated as the "deemed transferor" of the trust property and the child's transfer tax brackets would be used as a measuring rod for

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[13] The value of the property which is the subject of the generation-skipping transfer is added to (1) prior generation-skipping transfers of the deemed transferor, (2) any taxable gifts made by him after December 31, 1976, and (3) where the generation-skipping transfer occurs after (or as a result of) the death of the deemed transferor, the deemed transferor's taxable estate. A tentative transfer tax is computed on the total value of these transfers; from the tentative tax is subcontracted the transfer tax on all transfers in the tentative tax base other than the generation-skipping transfer in question.

purposes of determining the tax imposed on the generation-skipping transfer.

Also, under the Act, in a case where there are simultaneous generation-skipping transfers which flow through the same deemed transferor and result from the same event (usually the death of the deemed transferor), the tax on all such transfers is to be allocated pro rata (spreading the effect of the progressive marginal rates rather than stacking one transfer on top of another). For example, assume that the grantor establishes trust A, having a value of 60, for his child for life with remainder to great grandchild A; the grantor's spouse establishes trust B, having a value of 40, for the child for life with remainder to great grandchild B. Upon the death of the child, the value of trusts A and B would be added to the child's estate, a tax would be computed on the total value of 100 and (assuming no change in relative value of trusts A and B after they are created) 60 percent of the tax would be imposed on the transfer of trust A, and 40 percent of the tax would be imposed on trust B.

Deemed transferor.—Under the Act, the deemed transferor of the generation-skipping transfer is always the parent (whether or not living at the time of the transfer) of the transferee of the trust property who is most closely related to the grantor of the trust in all cases except where (1) that parent is not a younger generation beneficiary of the trust at any time, and (2) there is another ancestor (grandparent, great grandparent, etc.) of the transferee who is related by blood or adoption (and not by marriage) to the grantor of the trust who is a younger generation beneficiary of the trust. If both of these conditions are satisfied, then the ancestor who is also a younger generation beneficiary will be considered the deemed transferor.

For purposes of these rules, an individual related to the grantor by blood or adoption is always to be treated as being more closely related than an individual who is related to the grantor by marriage.

For example, assume a trust for the benefit of the grantor's grandchild for life with remainder to the grantor's great grandchild; the grandchild is the deemed transferor when the trust property passes to the great grandchild. Also, if the trust is for the benefit of the spouse of the grantor's grandchild for life, with remainder to the great grandchild, the grandchild (not his spouse) is the deemed transferor (because he is the parent of the transferee more closely related to the grantor) and when the grandchild's spouse dies, the value of the trust property will be added to the grandchild's taxable transfers for purposes of determining the tax rate.[14]

If the trust were for the benefit of the grantor's child for life, with remainder to the grantor's great grandchild, the child would be the deemed transferor (because the great grandchild's parent was not a younger generation beneficiary under the trust).

If the trust were for the benefit of the grantor's nephew for life, then the nephew's son for life, with the remainder to the grantor's great

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[14] If the grandchild is still alive when the generation-skipping transfer occurs, the deemed transfer is to be taken into account for purposes of determining the marginal tax rate to be imposed with respect to later deemed transfers attributable to him; however, the deemed transfer is not to be taken into account for purposes of determining transfer tax rates on the grandchild's gifts, or his estate.

grandchild, the nephew would be the deemed transferor upon his death, but upon the death of the nephew's son, the grantor's grandchild (the great grandchild's parent) would be treated as the deemed transferor (because no ancestor of the great grandchild was a younger generation beneficiary under the trust).

If the trust were a discretionary trust, with the trustee having the power to allocate income between the grantor's grandchild and the grantor's nephew's son, with remainder to the grantor's great grandchild, the grantor's grandchild would be the deemed transferor (because he was the parent of the transferee and was also one of the younger generation beneficiaries under the trust as that term is defined in the Act).

Where the trust is created for the benefit of persons outside of the grantor's family (i.e., friends, employees, etc.), the deemed transferor is the parent of the transferee having the closest "affinity" or relationship with the grantor. Generally, this will be the person named in the trust instrument or the lineal descendant of that person having the intervening interest or power in the trust.

For example, if a trust were created for the benefit of the grantor's butler (who is 13 years younger than the grantor) for life, then the butler's children for life, with the remainder to their issue, the butler would become a deemed transferor upon his death, and each of his children would become a deemed transferor upon his or her death.[15]

As noted above, in the case of a sprinkling trust, the taxable termination does not occur until the interest of the last member of a generation of beneficiaries has terminated. At that point, each member of that generation becomes the deemed transferor with respect to trust property transferred to his descendants.

For example, assume that the grantor creates a sprinkling trust for the benefit of his grandchildren A, B, and C for life, with remainder to his great grandchildren. Upon the death of the survivor of A, B, and C, each of these three individuals becomes a deemed transferor with respect to any trust property passing to his children.

The Act also contains a rule to cover the situation where it is not clear under the will or trust instrument how the trust property is to be allocated. Under this rule, the property is presumed to pass pro rata to each beneficiary in proportion to the amount he would receive under a maximum exercise of discretion in his favor.[16] It is also to be presumed that discretion will always be exercised per stirpes (unless a contrary intention is expressed in the will or trust instrument).

For example, assume a trust for the lifetime benefit of grandchildren A, B, and C, with the remainder, in the discretion of the trustee, to the grantor's great grandchildren. A has two children, B has one child and C has three children. Upon the death of the survivor of A, B, and C, each would be treated as the deemed transferor with respect to one-

[15] This assumes that each of the butler's children are more than 37½ years younger than the grantor.

[16] Where someone holds a power of appointment allowing him to appoint trust property to anyone other than himself, his estate, or creditors, there would be numerous persons who theoretically might benefit under the trust. The Congress anticipated that the regulations will provide a series of presumptions to cover such cases and will provide, for example, that such a power will be exercised first on behalf of lineal descendants of the grantor who are members of the younger generation immediately succeeding the generation whose interests have all been terminated.

third of the trust property (because it would be presumed, in the absence of a contrary indication, that the discretion would be exercised per stirpes, and the maximum amount transferred to each of the three sets of great grandchildren under this presumption would be one-third of the trust property).

Under another rule in the Act, if any beneficiary of a generation-skipping trust is an estate, trust, partnership, corporation, or other entity (other than certain charities, charitable trusts and tax-exempt trusts), each individual having an indirect interest (as defined in regulations) in the generation-skipping trust, through means of the entity, is to be treated as a beneficiary of the generation-skipping trust for purposes of these rules.

Transferee.—In the case of a taxable distribution, the "transferee" for purposes of the tax on generation-skipping transfers is, of course, the person receiving the distribution. In the case of a taxable termination the "transferee" is generally any person who has a present interest or power in the trust or trust property after the termination.[17] For example, assume that a trust is created for the benefit of the grantor's nephew for life, then to the nephew's son for life and, upon the death of the nephew's son, the entire trust is to be distributed to the issue of the nephew's son, *per stirpes.* Upon the death of the nephew, the nephew's son is the transferee with respect to the entire trust (because he is entitled to all of the trust income). Upon the death of the nephew's son, each of his issue entitled to receive a portion of the trust assets is to be treated as a transferee to the extent of that portion. The same result would follow in the case of a trust which provided that, upon the death of the nephew, the income was to be distributed, on a discretionary basis, to the nephew's son and the son's issue with the principal to be distributed to the issue of the nephew's son upon the son's death; in this case, the nephew's son would be the transferee of the entire trust upon the death of the nephew.[18] Upon the death of the nephew's son, his issue would become the transferees.

The term "transferee" is to be further defined in regulations. The Congress intended that these regulations will prevent situations where attempts are made to minimize tax through the use of nominal transferees.

Liability for tax.—Neither the deemed transferor nor his estate is liable for the tax imposed under these provisions. Generally, it was anticipated that the tax will be paid out of the proceeds of the trust property.

In the case of a taxable distribution, however, the distributee of the property is personally liable for the tax to the extent of the fair mar-

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[17] Generally the person would receive his present interest immediately after the taxable termination. However, in certain cases, there might be an intervening interest in a person (i.e. a charity) which is not a transferee (sec. 2611(e)(7)). In this case, the transferee is the person having the next succeeding interest. (In the example which appears in the text, the nephew's son would be the transferee upon the death of the nephew, even if the trust provided that the income was to be paid to charity for 10 years after the date of the nephew's death. Of course, if the nephew's son died before the expiration of the 10-year intervening interest, no taxable termination would occur upon his death under the Act because the nephew's son would never have held anything other than a "future interest" in the trust (sec. 2613(b)(1)).)

[18] The nephew's son has an income interest in the entire trust, he represents the oldest generation then having a present interest or power and, for purposes of determing who is a transferee, it is presumed under the Act that any discretion with respect to the trust will be exercised *per stirpes* (sec. 2613(b)(3)).

ket value of the property which he receives (determined as of the date of the distribution).

In the case of a taxable termination, the trustee is personally liable for the tax. However, to minimize any undue administrative burden or hardship for the trustee, under the Act, the trustee is permitted to file a request with the Internal Revenue Service for information concerning the transfer tax rate bracket of the deemed transferor. Where the transfer is to a grandchild of the grantor of the trust, the trustee may also request information concerning the extent to which the $250,000 exclusion of the deemed transferor has not been fully utilized.[19] Under the Act, the trustee is not to be liable for tax to the extent that any shortfall in the payment of the tax ultimately determined to be due results from the trustee's reliance on the information supplied by the Internal Revenue Service.

In addition, any property transferred in a generation-skipping transfer is to be subject to a lien for the full amount of the tax payable with respect to that transfer until the tax has been paid in full, or becomes unenforceable due to the expiration of the statute of limitations.

Other rules

(1) *Basis adjustment.*—The basis of property which is subject to tax as a generation-skipping transfer is to be increased (but not above the value of this property used in determining the amount of the tax) by an amount equal to the tax imposed with respect to the appreciation element in the value of the property (determined as of the applicable valuation date). Property in a generation-skipping trust is also to receive the benefit of the "fresh start" based on a December 31, 1976, valuation date, which is provided, under the Act, for property passing or acquired from a decedent (in connection with the rules under the Act concerning "carryover basis"). Of course, this "fresh start" is only to be available to the extent that property passing through the trust is subject to the tax on generation-skipping transfers and the taxable transfer occurs at or after the death of the deemed transferor. Where these conditions are satisfied, property held in a generation-skipping trust, or by the grantor of a generation-skipping trust, on December 31, 1976, is to receive an adjustment to basis equal to the excess (if any) of the fair market value of the property on that date over the basis of the property in the hands of the trust or its grantor, for purposes of determining gain but not loss. Other issues in this area are to be determined under regulations and, to the extent practicable, the rules with respect to carryover basis in the case of property which is subject to the tax on generation-skipping transfers are to be similar to the rules which apply in the case of other property passing or acquired from a decedent. The trust is not to be eligible for the $60,000 minimum basis or the $10,000 exclusion for personal or household effects. (Even if these provisions were applicable, they would be fully utilized by the estate of the deemed transferor in almost every case.)

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[19] The trustee is also entitled to request from the Service a statement concerning the Service's basis for valuing property included in the generation-skipping transfer. See sec. 8(a) below, "Furnishing On Request of Statement Explaining Estate or Gift Tax Valuation."

(2) *Alternate valuation date.*—The Act provides that the alternate valuation date is to be available where a taxable termination occurs at the death of the deemed transferor. In this case, the election to use the alternate valuation date is to be made by the trustee of the generation-skipping trust (who is also the person liable for the tax under these circumstances) and it is not required that the executor of the deemed transferor's estate also elect the alternate valuation date (since different persons are liable for the tax and the estate and the trust may have a different investment experience during the 6-month period). The trustee is required to make a timely filing of the tax return (including any extensions) in order to receive the alternate valuation date. Each trustee of a trust in which there is a taxable termination may elect the alternate valuation date for the property subject to tax, regardless of whether any trustee of any other trust as to which there is a taxable termination upon the death of the deemed transferor also elects the alternate valuation date. However, where more than one taxable termination occurs in the same trust at the same time, the trustee must select the same valuation date for all the transferred property.

As explained above, where two or more members of the same generation have present interests in the same trust, a taxable termination generally does not occur until the last of these interests terminates. Under the Act, the alternate valuation date is also to be available in these circumstances. For example, if a trust is created providing discretionary distribution of income to the grantor's children, A, B, and C, with the remainder to be distributed to the grantor's great-grandchildren, then upon the death of the survivor of A, B, and C, the trustee could elect to use the alternate valuation date (6 months from the death of the survivor) with respect to all of the trust assets.

(3) *Transfers in contemplation of death.*—The Act also provides that where the deemed transferor dies within three years after a generation-skipping transfer, the transfer is to be treated as a generation-skipping transfer at the time of the decedent's death for purposes of the tax on generation-skipping transfers. (This is closely analogous to the estate tax treatment of gifts made within 3 years of the decedent's death under the Act for estate tax purposes.) In other words, the generation-skipping transfer is to be taxed, under these circumstances, at the deemed transferor's transfer tax rate taking into account his cumulative lifetime and deathtime generation-skipping transfers (and not just his adjusted taxable gifts as of the date of the generation-skipping transfer).

(4) *Nonresident aliens.*—If the deemed transferor of any generation-skipping transfer is a nonresident alien, the generation-skipping tax is to be imposed only to the extent that an estate or gift tax would be imposed in similar circumstances in the case of an outright gift or bequest by the alien.

(5) *Disclaimers.*—A beneficiary under a generation-skipping trust is permitted to disclaim his interest in that trust within the same time period and in the same manner as would any beneficiary of an outright gift or bequest. (For a more detailed discussion of the rules under the Act concerning disclaimers, see sec. 9(b) below, "Disclaimers.") The

Congress also wished to clarify that for purposes of the new disclaimer rules (sec. 2518), the event which triggers the 9-month period allowed for an effective disclaimer is the generation-skipping transfer (either a taxable termination or a taxable distribution).

(6) *Coordination with other estate and gift tax provisions.*—The Act provides that, to the extent consistent with the specific provisions concerning generation-skipping transfers, the rules of the Internal Revenue Code relating to gift tax are to apply in the case where the deemed transferor is alive at the time of the generation-skipping transfer, and the rules relating to the estate tax are to apply where the generation-skipping transfer occurs at or after the death of the deemed transferor.

(7) *Filing requirements.*—Generally, the reporting procedures to be followed in the case of a generation-skipping transfer are similar to those which apply in the case of a gift or estate tax (except that returns are to be filed with respect to all such transfers, regardless of whether the amount involved is sufficient to equal the amount of the minimum filing requirement with respect to the estate or gift tax). Filing is also to be required in the case of a generation-skipping transfer even if no tax is payable because of the $250,000 exclusion. More detailed rules with respect to reporting are to be prescribed in regulations.

To the extent practicable, the regulations are to provide that the return is to be filed by the trustee in the case of a taxable termination and by the distributee in the case of a taxable distribution. In the case of a generation-skipping transfer occurring before the death of the deemed transferor (generally a taxable distribution), the return is not due until 90 days after the close of the taxable year of the trust in which the transfer occurs. In the case of a transfer occurring at or after the death of the deemed transferor, the return is due at the later of (1) 90 days after the estate tax return of the deemed transferor is due, or (2) 9 months after the generation-skipping transfer occurs. (Rule (2) will generally be used in cases where a taxable termination is postponed because there are several present interests in the same trust.) The Treasury Department is given regulatory authority to require the filing of such information returns as may be needed. The Congress intended that the Service will establish procedures whereby the person required to file a return in connection with any generation-skipping transfer may receive information from the Service concerning the deemed transferor's marginal transfer tax rate base and other information which is necessary in order to properly prepare the return (or any refund claim).

Under the Act, generation-skipping transfers are generally subject to the procedural rules of Subtitle F which are applicable to gift and estate taxes but, of course, the specific provisions of the Act override this general rule in the area of filing requirements. However, where not inconsistent with the Act, the provisions of Subtitle F apply and the Internal Revenue Service, for example, may grant an extension of up to 6 months for filing any return required with respect to a generation-skipping transfer (sec. 6081), or grant an extension for the payment of the tax (see sec. 6161).

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Effective dates

Under the Act, these provisions apply generally to transfers made after April 30, 1976. However, the tax does not apply in the case of transfers under irrevocable trusts in existence on April 30, 1976, or in the case of decedents dying before January 1, 1982, pursuant to a will (or revocable trust) which was in existence on April 30, 1976, and which was not amended (except in respects which do not result in the creation of, or increase the amount of, a generation-skipping transfer) at any time after that date. The 1982 date is extended in certain cases where the testator is incompetent to change the disposition of his property.

For purposes of this transition rule, a change of trustee is not a change creating or increasing the amount of a generation-skipping transfer. Also, an amendment changing the beneficiaries, or a change in the size of the share used for the benefit of a particular beneficiary, does not disqualify the trust under the transition rule, so long as the number of younger generations provided for under the trust (or the potential duration of the trust in terms of younger generation beneficiaries) is not expanded and the total value of the interests of all beneficiaries in each generation below the grantor's generation is not increased. For example, assume a revocable trust was created prior to April 30, 1976, for the benefit of the grantor's nephews, A, B, and C, in equal shares for life, with the remainder to be distributed to the children of A, B, and C. A becomes disabled and the trust is modified to increase his share of the income; this does not disqualify the trust because it does not create or increase the amount of a generation-skipping transfer. Likewise, if the trust is amended to include nephew D as an income beneficiary, this would not disqualify the trust under the transition rules. However, if the trust were amended so that the income was to be held in trust for the lives of the children of A, B, and C, with the remainder distributed to the nephews' grandchildren, this would increase generation-skipping (by increasing the number of generations skipped) and would disqualify the trust. An amendment creating a power of appointment would also disqualify the trust if there were any possibility, under the power of appointment, of increasing the number of generations which might be skipped.

In some cases, a trust which is irrevocable on April 30, 1976, might also be subject to a power of appointment under which it might be possible for the property to continue to be held in trust for the benefit of new beneficiaries, some of whom might be members of the generation younger than any beneficiaries expressly covered under the trust prior to the exercise of the power. Under the Act, the grandfather provision will apply to such a trust which includes a limited power of appointment, so long as the exercise of the power (including the creation of a new trust) does not result in the creation of an interest which postpones, or suspends, the vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the trust. In the case where the power is exercised after April 30, 1976, by creating another power and the applicable rule against perpetuities is stated in terms of suspension of ownership or power of alienation, the grandfather provision will not apply if the second power can be exercised to suspend the absolute ownership or power of alienation of the property ascertainable without regard to the date of creation of the first power. For this purpose, the second power of alienation of the property for a period ascertainable without regard to the date of creation of the first power. For this purpose, the second power will not result in a loss of the grandfather protection if (1) the power can only be exercised so that it satisfies the suspension of ownership or power of alienation requirements, and (2) the applicable provisions in default of appointment also satisfy these requirements.

7. Orphans' Exclusion (sec. 2007 of the Act and new sec. 2057 of the Code)

Prior law

Prior to the Act, there was no provision which allowed an estate tax deduction from the value of the gross estate for the value of any interest in property which passes or has passed to an orphaned child of the decedent.

General reasons for change

For purposes of the Federal estate tax law, transfers to charities and surviving spouses are generally the only testamentary transfers which are treated more favorably than other testamentary transfers. The Congress believed, however, where an interest in property passes or has passed to a minor orphan, a limited deduction from the value of the gross estate of the decedent for such interest should be allowed. This is based on the view that during the child's minority there was a generally accepted responsibility on the part of the decedent to support the child, a responsibility which cannot be satisfied in this case by passing property to a surviving spouse to be used for the child's support.

Explanation of provision

The Act adds a new provision (sec. 2057) which, in general, provides a limited deduction from the value of the gross estate of a decedent for an amount equal to the value of any interest in property which passes or has passed to a minor child of the decedent. The deduction is allowed only if the child has no known surviving parent and the decedent does not have a surviving spouse. For purposes of this provision, a minor child, whether natural or by legal adoption, is any child of the decedent who has not attained the age of 21 years before the date of the decedent's death.

The aggregate amount of the deduction allowed under this provision may not exceed an amount equal to $5,000 multiplied by the excess of 21 over the child's attained age, in years, on the date of the decedent's death. For example, where interests in properties pass from the decedent to the decedent's minor child (and the other qualifications of this provision are met) whose age on the decedent's date of death is 15, the maximum amount allowable as a deduction is equal to $30,000 (the excess of 21 over the child's age of 15, i.e., 6, multiplied by $5,000).

In the case of divorced parents, where the decedent is survived by the other known parent, a deduction under this section will not be allowed. However, a relationship by legal adoption supplants the relationship by blood for purposes of this provision. Thus, the provision will allow a deduction to the estate of a deceased adoptive parent who is not survived by a spouse even though one or both of the natural parents of the child are known and surviving. However, an adoption will not supplant the relationship by blood where it can be shown that the adoption was motivated to obtain the benefits of this provision.

Subject to the limitations below, the amount allowed as a deduction cannot exceed the value of property which is included in determining the value of the gross estate and which passes or has passed from the decedent to the minor child. The determination of whether an interest in property passes or has passed from the decedent to a particular person is to be made in accordance with rules prescribed under present law for marital deduction purposes (sec. 2056(d)).

With respect to interests in property which pass or have passed to a minor child, generally, only those interests will be taken into account which are of the quality that, if they passed to a surviving spouse, would have been allowable as a marital deduction under section 2056 (b) (pertaining to life estates or other terminable interests). However, an interest will not be treated as a terminable interest solely because the property will pass to another person if the child dies before the youngest then living child of the decedent attains age 21.

Effective date

The amendments made by this provision are to apply to the estates of decedents dying after December 31, 1976.

8. Administrative Changes

a. Furnishing On Request of Statement Explaining Estate or Gift Valuation (sec. 2008(a) of the Act and sec. 7517 of the Code)

Prior law

Under the estate tax law, the value of the gross estate or the value of a gift is reported by the executor of an estate or donor of a gift, as the case may be, at what he believes to be fair market value at the date of death of a decedent (or alternate valuation date, if elected), in the case of an estate or at the time the gift was made in the case of a gift. The Internal Revenue Service is authorized to make such inquiry as is necessary to determine the correctness of the return of the taxpayer and make a determination or proposed determination as to the value of any interests, rights, or powers with respect to property, whether real or personal, for estate or gift tax purposes. In these situations, there was no administrative provision under prior law which provided an affirmative requirement on the part of the Internal Revenue Service to disclose the method or basis by which the Service arrived at its determination of value.

Reasons for change

The Congress believed that, in those situations where the Service has made a determination as to the value of an item of property which differs from the value of the property as reported by the executor or donor taxpayer, it should encourage resolution of differences at the earliest time. The Congress believed that this problem can best be resolved by each having full information as to how the other arrived at his valuation. Therefore, it appeared appropriate for the executor of an estate or the donor of a gift to be able to ascertain by what method the Service arrived at a valuation.

Explanation of provision

The Act provides that if the Internal Revenue Service makes a determination or a proposed determination of the value of an item of property for purposes of the estate or gift tax law, then, upon written request of the executor or donor (as the case may be), the Service is to furnish a written statement with respect to the value of such item of property.[1] This statement is to be furnished within 45 days of the later of the date the request for the statement is made or the date of the determination, or proposed determination, by the Service.

The written statement required to be furnished to the executor or donor, as the case may be, under this provision, is to explain the basis on which the valuation was determined or proposed and to set forth the details of any computation used in arriving at such value. In addition, the statement is to contain a copy of any written expert appraisal of the property made by or for the Service.

The statement to be furnished by the Service is intended to provide the executor of an estate or the donor of a gift with sufficient information for such executor or donor to determine the methods of valuation and computations used by the Service. The statement is not intended to be a final representation of the Service's position and, consequently, the value of the item of property as determined or proposed by the Service with respect to which the statement is furnished, and the method and computations used in arriving at such value, is not to be binding on the Service.

Effective date

This amendment is effective for estate tax purposes as to estates of decedents dying after December 31, 1976, and for gift tax purposes to gifts made after December 31, 1976.

b. Special Rule for Filing Returns Where Gifts in Calendar Quarter Total $25,000 or Less (sec. 2008(b) of the Act and sec. 6075 of the Code)

Prior law

Under prior law, a gift tax return generally had to be filed for each calendar quarter in which a donor transferred by gift a present interest of an amount in excess of the annual $3,000 exclusion per donee. Any gift of a future interest must be reported on a gift tax return for the quarter in which the gift is made, regardless of the amount of the gift. Special filing requirements are provided for qualified charitable transfers.

A Federal gift tax return, if required, is due on or before the 15th day of the second month following the close of the calendar quarter in which a gift is made, unless an extension of time has been granted.

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[1] These provisions are also intended to apply with respect to generation-skipping transfers.

General reasons for change

Prior to the enactment of the Excise, Estate and Gift Tax Adjustment Act of 1970,[2] the due date for filing a gift tax return was April 15 following the calendar year in which a gift was made. This Act provided a requirement for the quarterly filing of gift tax returns, except for certain gifts to a charity, to provide for the more current payment of gift tax liabilities. Thus, it substantially limited the deferral of tax liability which had been available under prior law (this deferral could have been as much as 15½ months during which time the donor had the interest-free use of the funds due on the gift tax liability). Since the enactment of this provision, the total number of gift tax returns filed has continually increased.

For the three years prior to the enactment of the quarterly gift tax return filing requirement, the Internal Revenue Service processed an average of 142,000 gift tax returns. More specifically, for the calendar years ending December 31, 1967, 1968, and 1969, the Service processed 137,000, 139,000 and 151,000 gift tax returns, respectively. Since the enactment of the quarterly gift tax return filing requirement, the total number of gift tax returns processed by the Service has increased. For the three calendar years ending December 31, 1973, 1974 and 1975, for which data are available, the total number of gift tax returns processed by the Service was 244,000, 253,000, and 270,000 (preliminary), respectively. It is anticipated that with the modification of the quarterly gift tax return filing requirement provided for in this Act, the administrative burden will be alleviated somewhat.

In addition, an unintended substantive change in the law, because of the quarterly filing requirement, was brought to the attention of Congress. Under prior law, a marital deduction was allowed equal to one-half the value of the gifts made to a spouse (sec. 2523). However, the gift tax marital deduction is limited to the amount of gifts remaining after the annual exclusion of $3,000 has been deducted from the total amount of the gifts passing to the spouse (sec. 2524).

Prior to the change in the gift tax law which required the quarterly filing of gift tax returns, the limitation on the marital deduction allowed was computed on the basis of the aggregate amount of gifts made to a spouse during a calendar year. If the aggregate amount of gifts made to a spouse during a calendar year was equal to or greater than $6,000, the marital deduction was unaffected by the limitation.

The limitation on the marital deduction allowed with respect to interspousal gifts made after December 31, 1970, is applied on a quarterly basis rather than on a calendar year basis, which places a premium on the amount and timing of an interspousal gift in order not to lose part of the marital deduction.

The effect of the change in the filing requirements may be illustrated by the following example. If, prior to the filing requirements changes, the donor made separate gifts of $4,000 and $2,000 in different calendar quarters of a year, no gift tax would be imposed with respect to those gifts (total gifts of $6,000 less $3,000 for the marital deduction and $3,000 for the annual exclusion). If the same amount of gifts were given in different quarters under the quarterly filing sys-

[2] Public Law 91–614.

tem, no gift tax would be imposed with respect to the $4,000 gift ($4,000 gift less $1,000 marital deduction and $3,000 annual exclusion). The marital deduction is only $1,000 because it is limited to the amount of gifts remaining after deduction for the annual exclusion. However, for the subsequent quarter in which the $2,000 gift is made, the donor would have been treated as making $1,000 in taxable gifts ($2,000 gift less $1,000 marital deduction and no amount of the exclusion is taken into account since it has been used against the value of the gift made in the preceding quarter). Thus, the donor's taxable gifts for the year have been increased by $1,000 solely because of the quarterly filing requirements.

The Act alleviates, in part, this problem by providing an exception to the quarterly gift tax return filing requirement where total cumulative taxable gifts made during a calendar quarter do not exceed $25,000. The problem will also be alleviated by the gift tax marital deduction changes made by the Act. This change also decreases the burden of compliance for donors of smaller amounts of taxable gifts.

Explanation of provision

The Act provides that a gift tax return is required to be filed on a quarterly basis only when the sum of (1) the taxable gifts made during the calendar quarter plus (2) all other taxable gifts made during the calendar year (and for which a return has not yet been required to be filed) exceeds $25,000. For example, where a donor makes a taxable gift valued at $23,000 in the first quarter of a calendar year and an additional taxable gift valued at $6,000 in the second quarter of the same calendar year, a gift tax return reporting the aggregate amount of taxable gifts is not required until the 15th day of the second month following the close of the second quarter. If, in addition to these two taxable gifts, a third taxable gift valued at $10,000 is made during the third quarter of the same calendar year and no other taxable gifts are made during such calendar year, the gift tax return reporting the taxable gift made during the third quarter is required by the 15th day of the second month following the close of the fourth calendar quarter of the calendar year in which the $10,000 taxable gift was made.

For all transfers made in the calendar year which are subject to the gift tax filing requirements but do not exceed $25,000 in taxable gifts, a return need be filed only by the filing date for gifts made in the fourth calendar quarter of the calendar year. In the case of nonresidents not citizens of the United States, the same rules are to apply except that $12,500 is substituted for $25,000.

Effective date

This provision is effective for gifts made after December 31, 1976.

c. *Public Index of Filed Tax Liens (sec. 2008(c) of the Act and sec. 6323 of the Code)*

Prior law

Under prior law (sec. 6323), a Federal tax lien takes priority, with certain relatively limited exceptions, over interests in the property subject to the lien which are held by purchasers, holders of a security interest, mechanic's lienors and judgment lien creditors, if notice of the tax lien has been appropriately filed before such interests are acquired.

Reasons for change

Under prior law, the filing of a notice of lien was effective even if the notice of lien had not been recorded; thus, it was possible that prospective purchasers or secured creditors of the particular property may not had an opportunity to discover the existence of the lien. The Congress was made aware of a recent case* in which the Government was held to have satisfied the requirements for filing notices of lien even though, through an oversight by a State official, the notices of lien were not recorded on the public Federal tax lien index. A title search of the property did not reveal the existence of the tax liens and, despite the lack of actual notice, purchasers of the property took title subject to the Federal tax liens.

Explanation of provision

The Act provides that a notice of a lien is not to be treated as meeting the filing requirements unless a public index of the lien is maintained at the district Internal Revenue Service office in which the property subject to the lien is situated. For this purpose, an index of liens affecting real property would be maintained in the district office for the area in which the real property is physically located. In the case of liens affecting personal property, the index would be maintained in the district office for the area in which the residence of the taxpayer is located at the time the notice of lien is filed.

The Congress understood that the Internal Revenue Service also will use its best efforts to make follow-up checks on the recordation or indexing notices of lien which are filed after the date of enactment with offices designated under local law as the place for filing notices of *effective date* lien.

The Act is effective on February 1, 1977, in the case of notices filed on or after October 4, 1976. In the case of liens filed before October 4, 1976, the Act is effective on July 1, 1977.

9. Miscellaneous Provisions

a. Inclusion of Stock in Decedent's Estate Where Decedent Retains Voting Rights (sec. 2009(a) of the Act and sec. 2036 of the Code)

Prior law

Under prior law, an inter vivos transfer of property which had been made by a decedent is required to be included in the decedent's gross estate if he retained for his lifetime either the right to possess or enjoy the property or the right to designate the person who will possess or enjoy the property.[1] In *United States v. Byrum*,[2] the Supreme Court held that the stock of a closely held corporation was not includible in the decedent's gross estate where the decedent had irrevocably transferred the stock in trust reserving the power to (1) remove the trustee and appoint another corporate trustee, (2) vote the closely held stock, (3) veto the sale or other transfer of the trust property, and (4) veto any change in investments. The Court found that the reserved rights

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Adams v. United States, —— F. Supp. ——, 76-1 USTC ¶ 9457 (S.D.N.Y. 1976).

[1] Sec 2036.

[2] 408 U.S. 125 (1972).

did not constitute retained enjoyment of the stock or the right to designate the person or persons who would enjoy the stock or the income from the stock.

Reasons for change

The Congress believed that the voting rights are so significant with respect to corporate stock that the retention of voting rights by a donor should be treated as the retention of the enjoyment of the stock for estate tax purposes. The Congress believed that this treatment is necessary to prevent the avoidance of estate taxes.[3]

Explanation of provision

The Act would provide that the retention of voting rights in transferred stock is to be treated as a retention of the enjoyment of the stock. The value of the stock is to be includible in a decedent's gross estate if the decedent retained the voting rights for his life, for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death. The provision is to apply even if the stock is issued by a corporation which had not been directly or indirectly controlled by the decedent. For purposes of the provision, the capacity in which the decedent could exercise the voting rights is immaterial.

Effective date

The amendment is to apply to transfers made after June 22, 1976.

b. Treatment of Disclaimers (sec. 2009 of the Act and secs. 2041, 2045, 2055, 2056, 2514, and 2518 of the Code)

Prior law

In general, a disclaimer (or renunciation) is a refusal to accept the ownership of property or rights with respect to property. If recognized for Federal transfer tax purposes, a disclaimer of property receivable by inheritance or gift is not treated as a taxable transfer by the person making the disclaimer. In addition, a disclaimer may result in increasing the amount to the estate tax charitable or marital deduction if the property disclaimed passes to a charity or a surviving spouse.

Under prior law, the tax consequences resulting from an effective disclaimer in certain cases was prescribed under several code provisions. Under the provisions relating to powers of appointment, a disclaimer of a general power of appointment is not treated as a release of the power and, therefore, is not a taxable transfer.[4] Under the estate tax charitable and marital deduction provisions, property is considered to pass from the decedent to the person who receives it by

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[3] One commentator has suggested that "[t]he 'ultimate' in estate planning for most controlling stockholders of closely held corporations is the avoidance of a Federal estate tax on corporate voting shares that they have transferred to a trust in which they have reserved the uninterrupted right to continue voting the shares." Pressment, "Effect of Tax Court's Gilman Decision on Estate Planning for the Close Corporation," 44 *The Journal of Taxation*, 160 (March 1976). This commentator further suggests that the value of the gift might be reduced by the value attributable to the retained voting rights. If this is done, the value attributed to voting rights would not be subject to either the gift tax at the time of the gift or, under the *Byrum* decision, the estate tax upon the death of the donor.

[4] Sections 2041(a)(2) and 2514(b).

reason of the disclaimer.[5] Under the gift tax regulations relating to transfers in general, a disclaimer must comply with local law in order to be valid for gift tax purposes.[6]

Prior law does not provide either definitive rules as to what constitutes a "disclaimer" or rules of general application concerning the tax consequences of a disclaimer. The Federal tax consequences of a disclaimer has largely depended upon its treatment under local law, i.e., its treatment as a disclaimer so that the person disclaiming is not considered to have held title to the property at any time. Although the Commissioners on Uniform State Laws proposed a Uniform Disclaimer Act in 1973, the State laws relating to disclaimers are not uniform. In addition, some States have not enacted any statutory provisions and the disclaimer rules, if any, have been developed by the courts. As a result, identical refusals to accept property may be treated differently for estate and gift tax purposes depending upon applicable local law.

For many of the estate and gift tax provisions described above, no specific time period is prescribed within which a disclaimer must be made in order to be recognized for Federal transfer tax purposes. Except in the case of the treatment of disclaimers affecting the estate tax marital or charitable deductions (which must be made before the due date of the return), the disclaimer is required to be made within a "reasonable" time after the person disclaiming learns of the existence of his interest in a property transfer. In one case, a remainderman, who was aware of his interest, was considered to have made a disclaimer of his remainder interest within a "reasonable" time for gift tax purposes when he disclaimed shortly after the expiration of a life tenancy which had continued for 19 years after the grantor's death.[7] The decision in this case might not apply in other cases involving the same facts depending upon the applicable local law.

Reasons for change

The Congress believed that definitive rules concerning disclaimers should be provided for estate and gift tax purposes to achieve uniform treatment.[8] In addition, the Congress believed that a uniform standard should be provided for determining the time within which a disclaimer must be made.

Explanation of provision

The Act provides definitive rules relating to disclaimers for purposes of the estate, gift and generation-skipping transfer taxes. If the requirements of the provision are satisfied, a refusal to accept property is to be given effect for Federal estate and gift tax purposes even if the applicable local law does not technically characterize the refusal as a "disclaimer" or if the person refusing the property was considered to have been the owner of the legal title to the property before refusing

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[5] Sections 2055(a) and 2056(d).

[6] Treas. Reg. Sec. 25.2511–1(c).

[7] *Kenneth v. Commissioner*, 480 F. 2d 57 (8th Cir. 1973), *rev'g* 58 T.C. 352 (1972).

[8] It is noted that many professional study groups have recommended that definitive rules be provided with respect to the treatment of disclaimers for estate and gift tax purposes. See American Bar Association recommendation number 1974–2, 27 Tax Lawyer 818 (1974); American Law Institute recommendations 21 and 22. "Federal Estate and Gift Taxation: Recommendations Adopted by the American Law Institute," pp. 39–41 (1968); "Tax Reform Studies and Proposals: U.S. Treasury Department," p. 387 (1969); American Bankers Association, "Commentary on Proposed Tax Reform Affecting Estates and Trusts," p. 166 of appendix A (1973).

acceptance of the property. If a qualified disclaimer is made, the Federal estate, gift, and generation-skipping transfer tax provisions are to apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer.

A person making a qualified disclaimer is not to be treated as having made a gift to the person to whom the interest passes by reason of the disclaimer. In addition, the disclaimer is to be taken into account for purposes of the estate tax charitable and marital deduction as under present law. A qualified disclaimer of a general power of appointment is not to be treated as a release of the power.

Under the Act, a "qualified disclaimer" means an irrevocable and unqualified refusal to accept an interest in property that satisfies four conditions. First, the refusal must be in writing. Second, the written refusal must be received by the transferor of the interest, his legal representative, or the holder of the legal title to the property not later than 9 months after the day on which the transfer creating the interest is made. However, if later, the period for making the disclaimer is not to expire in any case until 9 months after the day on which the person making the disclaimer has attained age 21. For purposes of this requirement, a transfer is considered to be made when it is treated as a taxable transfer, i.e., a completed transfer for gift tax purposes with respect to inter vivos transfers or upon the date of the decedent's death with respect to testamentary transfers. Third, the person must not have accepted the interest or any of its benefits before making the disclaimer. For purposes of this requirement, the exercise of a power of appointment to any extent by the donee of the power is to be treated as an acceptance of its benefits. In addition, the acceptance of any consideration in return for making the disclaimer is to be treated as an acceptance of the benefits of the interest disclaimed. Fourth, the interest must pass to a person other than the person making the disclaimer as a result of the refusal to accept the property. For purposes of this requirement, the person making the disclaimer cannot have the authority to direct the redistribution or transfer of the property to another person and be treated as making a "qualified" disclaimer.

The Congress intended to make it clear that the 9-month period for making a disclaimer is to be determined in reference to each taxable transfer. For example, in the case of a general power of appointment, where the other requirements are satisfied, the person who would be the holder of the power will have a 9-month period after the creation of the power in which to disclaim and the person to whom the property would pass by reason of the exercise or lapse of the power would have a 9-month period after a taxable exercise, etc., by the holder of the power in which to disclaim. Further, in the case where the transfer is for the life of an income beneficiency with remainder to another person, both the life tenant and the remainderman would have to disclaim with the 9-month period after the transfer is made. However, in the case where a lifetime transfer is included in the transferor's gross estate because he had retained an interest in the property, the person who would receive an interest in the property during the lifetime of the grantor will have a 9-month period after the original transfer in which to disclaim and a person who would receive an interest in the property on or after the grantor's death would have a 9-month period after the grantor's death in which to disclaim if the other requirements of the provision are satisfied (e.g., that person had not accepted the interest or any of the benefits attributable to the interest before making the disclaimer).

Under the Act, a disclaimer with respect to an undivided portion of an interest is to be treated as a qualified disclaimer of the portion of the interest if the requirements are satisfied as to the undivided portion of an interest. Also, a power with respect to property is to be treated as an interest in the property for purposes of the provisions.

Effective date

The amendments apply with respect to transfers creating an interest in the person disclaiming made after December 31, 1976. In the case of transfers made before January 1, 1977, the rules relating to disclaimers under prior law, including the period within which a disclaimer must be made, are to continue to apply to disclaimers made after December 31, 1976.

c. *Changes Relating to Certain Retirement Benefits: Estate and Gift Tax Exclusions for Qualified Retirement Benefits (sec. 2009 of the Act and secs. 2039 and 2517 of the Code)*

Prior law

Since 1954 the value of an annuity or other payment receivable by any beneficiary (other than the executor) under certain retirement programs has been excludible from an individual's gross estate, except to the extent that the value is attributable to payments or contributions which were made by the decedent during his lifetime. The exemption applies to benefits under an employee's trust forming part of a qualified pension, stock bonus, or profit-sharing plan (sec. 401(a)), a retirement annuity contract purchased by an employer pursuant to a qualified plan (sec. 403(a)) or a retirement annuity contract purchased for an employee by an employer which is a tax-exempt educational institution, public charity or religious organization,[9] and to survivor benefits payable to certain members of the armed forces.

Under prior law the estate tax exclusion (sec. 2039(c)) did not apply to benefits payable under an individual retirement account, an individual retirement annuity, or an individual retirement bond ("individual retirement account"),[10] although these programs qualified for favorable income tax treatment on account of provisions adopted as part of the Employee Retirement Income Security Act of 1974 ("ERISA"). This limitation paralleled the treatment of benefits payable upon the death of a self-employed individual under an H.R. 10 plan.

Under the estate tax law, the estate tax exclusion is limited to the part of the value of qualifying benefits which represent payments or contributions made by the employer. However, under prior contributions made on behalf of an individual while he was self-employed were regarded as employee contributions.

The gift tax provisions (under sec. 2517) which were adopted in 1958, parallel the estate tax exclusion. The exercise or nonexercise by an

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[9] The Code refers specifically to an organization referred to in section 170(b)(1)(A)(ii) or (vi) or a religious organization other than a trust.

[10] Individual retirement accounts and annuities are described in sections 408 (a) and (b). Individual retirement bonds are described in section 409(a).

employee of an election or option whereby an annuity or other payment becomes payable to any beneficiary at or after the employee's death is not regarded as a transfer subject to the gift tax if two conditions are satisfied. First, the annuity or other payment must be provided under a tax-qualified employee's trust or retirement annuity contract, or a retirement annuity contract purchased by a qualifying tax-exempt organization, or for certain retired members of the armed forces. Second, the exclusion does not apply to that part of the value of the annuity or other payment available to employee's contributions.

Under prior law, the gift tax exclusion did not apply to transfers made in connection with an individual retirement account. Moreover, payments or contributions made on behalf of a self-employed individual were regarded as though they had been made by an employee, so that the gift tax exclusion did not apply.

Reasons for change

The Congress believed that the estate and gift tax exclusions presently available to taxpayers participating in many retirement programs should be extended to cover those who establish an individual retirement account, as well as the self-employed. Both the individual retirement account provisions adopted as part of ERISA and the provisions of H.R. 10 were designed to encourage the establishment of voluntary retirement plans and, therefore, these plans should be accorded the same estate and gift tax exclusions available to employees covered under other qualified retirement plans.

The Congress, however, believed that it is no longer appropriate to continue the estate tax exclusion with respect to amounts payable in a single lump sum under a retirement plan. Benefits paid in a lump sum will normally generate sufficient cash to cover the estate tax liability attributable to the inclusion of the benefits in the decedent's gross estate.

Explanation of provisions

The Act amends present law (sec. 2039) generally to exclude from the value of a decedent's gross estate the value of an annuity receivable by a beneficiary under an individual retirement account. The exclusion applies only to the portion of the account attributable to contributions which were allowable as a deduction for income tax purposes (sec. 219).[11] The exclusion also is to be available with respect to a roll-over contribution of a distribution from another qualified plan even though no income tax deduction is allowable for the rollover contribution. Where the individual retirement accounts contains contributions for which a deduction was not allowable, the decedent's gross estate will include that portion of the value of the amount receivable under his individual retirement account as the total amount which was not allowable as an income tax deduction (other than a rollover contribution) bears to the total amount paid to or for the individual retirement account (including rollover contributions). This limitation will not apply if the nondeductible amounts were returned to the decedent prior to his death.

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[11] The exclusion is also to be available in the case where contributions were deductible for income tax purposes under a spouse-covered individual retirement account because the deduction allowed under section 220 for such an account is in lieu of the deduction provided under section 219. (See sec. 408 et seq.).

The Act also provides that contributions or payments made on behalf of a decedent to a qualified retirement plan while he was a self-employed individual are, to the extent allowable as a tax deduction, to be treated the same as a contribution made by an employer. As a result, benefits payable on account of the death of a self-employed individual under an H.R. 10 plan are to be exempt from estate taxation, unless they are attributable to plan contributions made on the individual's behalf which were not allowable as a deduction for income tax purposes (sec. 404).

As a result of the Act, the interest of a taxpayer's spouse under the community property laws in benefits accumulated under an individual's retirement account or H.R. 10 plan is also to qualify for the estate tax exclusion when the spouse predeceases the taxpayer.

The Act, however, limits the estate tax exclusion to an annuity or payments other than a lump sum distribution (described in sec. 402 (e)(4)) receivable under a qualifying program. Qualification for the estate tax exclusion is not affected by the mere existence of a right in a party, such as the plan's benefits committee, to select whether the benefits are paid in a lump sum or as an annuity so long as the right to select is irrevocably exercised no later than the earlier of the date the estate tax return is filed, or the date on which the return is required to be filed (including extensions of time to file).

In the case of an individual retirement account, the estate tax exclusion applies only to amounts receivable as an annuity. For this purpose, a distribution from an individual retirement account to a beneficiary does not have to be in the form of a typical commercial annuity contract to qualify for the exclusion. Generally, the exclusion is to be available in situations where a liquidity problem might exist because the schedule of payments to be made from the account will not provide current funds to pay the estate tax. Under the Act, the exclusion will be available if the distribution from an individual retirement account to the beneficiary consists of an annuity contract or other arrangement providing for a series of substantially equal periodic payments to be made to a beneficiary (other than the executor) for his life or over a period extending for at least 36 months after the date of the decedent's death. For this purpose, payments under an annuity contract are to be considered to be "substantially equal" under a variable annuity if the variance in payments is not solely attributable to tax avoidance motives. Of course, the annuity or other arrangement need not provide payments for the life of the beneficiary. Generally, satisfaction of the 3-year payment standard will be based on the payment provisions of the account or the settlement option, if any, elected no later than the earlier of the date the estate tax return is filed or the date on which the return is required to be filed (including extensions of time to file).

Comparable extensions are made by the Act in the gift tax exclusion. The exclusion is modified to cover an annuity or other payment provided under an individual retirement account. In addition, contributions or payments made under a qualified retirement plan on behalf of a self-employed individual are, to the extent allowable as an income tax deduction, to be deemed to have been made by an employer so that the gift tax exclusion will be available (sec. 2517(a)).

Effective date

The amendments made by the Act apply to the estates of decedents dying after December 31, 1976. The modifications apply to transfers by gift made after December 31, 1976.

d. Changes Relating to Certain Retirement Benefits: Gift Tax Treatment of Certain Community Property (sec. 2009 of the Act and sec. 2517 of the Code)

Prior law

In 1972, the estate tax exclusion for interests in certain qualified plans was amended to ensure that no portion of the employer contributions would be includible in the gross estate of the employee's spouse if the spouse predeceased the employee and the couple had resided in a community property State. This amendment was designed to overturn a revenue ruling (Rev. Rul. 67–278, 1967–2 C.B. 323), which held that, if under community property laws the deceased spouse had a vested interest in one-half of such amounts, this half was includible in the spouse's gross estate but was not eligible for the exclusion because the deceased spouse was not an employee covered under the plan.

However, no corresponding change was made in the gift tax provisions. As a result, the Internal Revenue Service ruled (Rev. Rul. 75–240, 1975–1 C.B. 314) that, if an employee predeceases the employee's spouse in a community property State, the surviving spouse is to be treated as having made a gift of one-half of any benefit payable to other beneficiaries. This result would not occur in a non-community property State.

Reasons for change

The Congress believed that the treatment described above is discriminatory and should not be allowed to continue. It was the view of the Congress that the provisions excluding from the estate and gift tax interests in qualified plans should have uniform application in common law and community property States regardless of which spouse dies first.

Explanation of provision

Consequently, the Act provides a gift tax exclusion for the value, to the extent attributable to tax deductible contributions, of any interest of a spouse in specified employee contracts, or trust or plan payments, where two conditions exist.

First, an employer must have made contributions or payments on behalf of an employee (or former employee) under an employee's trust forming a part of a qualified pension, stock bonus, or profit-sharing plan, a retirement annuity contract purchased under a qualified plan, or a retirement annuity contract purchased for an employee by an employer which is a tax-exempt educational organization, charity or religious organization; or a taxpayer (regarded as an employee for gift tax purposes) must have made contributions or payments to an individual retirement account. Second, the amount involved cannot be considered a non-tax deductible employee contribution. Where these two conditions exist, the value of the non-employee's interest payable to other beneficiaries upon the employee's death is to be excluded from the taxable gifts of the surviving spouse to the extent the value arises solely by reason of the spouse's interest in the community income of the employee under the community property laws of the State.

However, the Act does not, in the case of the nonemployee spouse in the community property State, provide any exclusion for a property interest to the extent that it is attributable to the non-tax deductible contributions of the employee spouse. Thus, the surviving spouse's community interest attributable to contributions made by the deceased employee spouse could be subject to the gift tax, as under prior law.

The Act will, therefore, have the effect of equating the gift tax treatment that occurs in a community property State upon the death of an employee's spouse with that resulting upon the death of the employee.

The provisions of the Act will also equate the gift tax treatment that occurs upon the lifetime transfer of qualified benefits by employees in a community property State with the result that occurs in a common law State.

Effective date

The amendment applies to transfers made after December 31, 1976.

c. *Income Tax Treatment of Certain Selling Expenses of Trusts and Estates (sec. 2009 of the Act and sec. 642(g) of the Code)*

Prior law

Generally, an estate or trust is not permitted to deduct any item for income tax purposes if that item is deducted for estate tax purposes as an administration, funeral, etc., expense or as a loss. Under prior law, a number of courts held that selling expenses may be used to reduce the amount realized on the sale of property by an estate trust even though those selling expenses are deducted for estate tax purposes. See, for example, *Estate of V. E. Bray* v. *Commissioner*, 396 F. 2d 452 (6th Cir. 1968).

Reasons for change

The Congress believed that there should not be different tax treatment for items which are considered offsets to the amount realized on the sale of property as opposed to items for which deductions would be allowed.

Explanation of provision

The Act amends prior law to provide that amounts cannot be used to offset the amount of the sale price of property if such amount is also deducted for estate tax purposes as administration, funeral, etc., expenses or as losses.

Effective date

This amendment is effective for taxable years ending after the date of enactment (October 4, 1976).

f. Estate Tax Credit for Payment in Kind (sec. 2010 of the Act)

Prior law

In addition to legal tender, it is lawful for the Secretary of the Treasury to accept checks or money orders in payment for estate tax liability. Under prior law, there was no provision authorizing the Secretary of the Treasury to accept other forms of payments, such as the conveyance of real property.

Reasons for the change

The Congress believed that the Secretary of the Treasury should be authorized to accept payment of estate tax in kind in the case of the estate of LaVere Redfield. In this way, a forced sale of certain land bordering the Toiyabe National Forest could be avoided and the property could be transferred to the Secretary of Agriculture for administration by the National Forest Service.

Explanation of provision

The Act allows the Secretary of the Treasury to accept conveyance of real property bordering the Toiyabe National Forest as payment of estate tax imposed on the estate of LaVere Redfield. The Act provides, however, that interest will accrue if the property is not conveyed expeditiously.

Effective date

This amendment is effective on the date of enactment (October 4, 1976).

Revenue Effect of Estate and Gift Tax Provisions

It is estimated that the Estate and Gift Tax provisions will reduce receipts by $728 million in fiscal year 1978 and $1,449 million in fiscal year 1981. However, in the long run (18 to 20 years), it is estimated there will be a net revenue gain from these provisions which will result in a net increase in receipts of $260 million. These estimates are set forth in the table immediately following:

ESTIMATED EFFECT ON FISCAL YEAR RECEIPTS OF THE ESTATE AND GIFT TAX CHANGES

[In millions of dollars]

	Fiscal year—					
	1977	1978	1973	1980	1381	Long ru
Unified rales and credit		−541	−756	−1,012	−1,380	−1,230
Marital		−153	−162	−171	−181	−154
Valuation		−14	−15	−16	−17	−14
Extension of time		−20	−24	−28	−33	(*)
Unification	(*)	(*)	(*)	(*)	(*)	300
Generation skipping				(*)	(*)	280
Carryover of basis	(*)	(*)	36	93	162	1,080
Total		−728	−921	−1,134	−1,449	263

T. MISCELLANEOUS PROVISIONS

1. Tax Treatment of Certain Housing Associations (sec. 2101 of the Act and secs. 216 and 528 of the Code)

Prior law

In developing a real estate subdivision or a condominium project, it is common for developers to form owners' associations as an integral part of the overall development. Generally, membership in the association is open only to owners of lots or dwelling units and is normally required as a condition of ownership. These associations are formed to allow individual homeowners, etc., to act together in managing, maintaining, and improving certain areas where they live. The purposes of the organization may include, for example, the administration and enforcement of covenants for preserving the architectural and general appearance of the development, the ownership and management of common areas such as streets, sidewalks, parks, swimming pools, etc., and the exterior maintenance and repair of property owned by its members.

The association is funded by either annual or periodic assessments of the members. Generally, there are two categories of assessments and expenditures made by the association. First, operating assessments are made to acquire, construct, administer, manage, maintain, and operate the areas and facilities common to all residential units. This includes the maintenance of parking areas, hallways, elevators, roofs, exterior of buildings, etc. Second, capital assessments are made to build up reserves for the replacement of equipment and facilities used in common. This includes the equipment and facilities used with respect to swimming pools, tennis courts, clubhouse facilities, etc.

Under prior law, generally a homeowners' association could qualify as an organization exempt from federal income tax (under sec. 501 (c)(4) of the Code) only if it met three requirements (Rev. Rul. 74–99, 1974–1 C.B. 131). First, the homeowners' association was required to serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit. Second, it could not have conducted activities directed to the exterior maintenance of any private residence. Third, common areas for facilities that the homeowners' association owned and maintained must be for the use and enjoyment of the general public.

If an association was unable to meet these three requirements, it ordinarily was taxed as a corporation. In general, this meant that the excess of current receipts over current expenditures at the end of the year was taxable to it unless the excess was refunded to the members or applied to the subsequent year's assessment. With respect to assessments for capital improvements, if the assessments were designated to be used solely for the purpose of making capital improvements and if the association homeowners had an equity interest in the association, the assessments were not treated as current income to the association but were treated as contributions to capital. Also, to the extent that the association's accumulated funds earn income, this income has been taxable to the association.

In contrast with the individual ownership of dwelling units in condominium projects and projects involving residential real estate management associations, the dwelling units in a cooperative housing project are owned by the cooperative housing corporation which leases the apartments or other dwelling units to tenant-stockholders who are required to purchase stock to be able to lease dwelling units. If a cooperative housing corporation meets certain requirements, a tenant-stockholder may deduct amounts which he pays to the corporation which represents his proportionate share of the corporation's real property taxes and mortgage interest.[1] Also, if a tenant-stockholder utilizes depreciable property leased from the cooperative housing corporation in a trade or business or for the production of income, the tenant-stockholder is allowed to take depreciation deductions with respect to his stock in the corporation (sec. 216(c)). In general, for a tenant-stockholder to qualify for these deductions, 80 percent or more of the gross income of the cooperative housing corporation must have been derived from individual tenant-shareholders. (However, stock owned, and dwelling units leased, by governmental entities empowered to acquire shares in a cooperative housing corporation for the purpose of providing housing facilities are not to be taken into account in determining whether this 80-percent test is satisfied.)

Cooperative housing corporations have generally been treated as taxable corporations. However, under prior law there was some ambiguity as to whether a cooperative housing corporation was entitled to deduct depreciation with respect to depreciable property leased to a tenant-shareholder (and with respect to which, if such property were used in a trade or business or for the production of income, the tenant-shareholder would take deductions for depreciation with respect to his stock in the corporation).[2]

Reasons for change

Most homeowners' associations have found it difficult to meet the three requirements set forth in Rev. Rul. 74–99, discussed above, and therefore, have not been able to qualify for tax exemption. To avoid being taxed on the excess of current receipts over current expenditures, the associations were required to refund such excess to the members or apply the excess to the subsequent years' assessment. In addition, it was not clear that assessments earmarked for major repair and improvements of a member's individual dwelling unit would not have been taxable.

Since homeowners' associations generally allow individual homeowners to act together in order to maintain and improve the area in which they live, Congress believes it is not appropriate to tax the revenues of an association of homeowners who act together if an

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[1] The allowance of these amounts as deductions to the tenant-stockholders does not prevent a cooperative housing corporation from deducting the mortgage interest and real property taxes it pays. Rev. Rul. 62–178, 1962–2 C.B. 91.

[2] A recent case has held that the corporation was not entitled to such deductions. *Park Place, Inc.*, 57 T.C. 767 (1972).

individual homeowner acting alone would not be taxed on the same activity. Consequently, these provisions exempt from income tax any dues and assessments received by a qualified homeowners' association which are paid by residential property owners who are members of the association, where the assessments are used for the maintenance and improvement of association property. This treatment is essentially equivalent to the tax treatment of individual homeowners who set aside amounts to maintain and improve their property.

Also, under these provisions an association's net investment income, and net trade or business income, is to be taxable, since an individual homeowner would be similarly taxed on investment income, such as interest earned on money set aside for improvements.

In the case of cooperative housing corporations, Congress believed that it was appropriate to resolve the ambiguity in prior law as to whether a cooperative housing corporation is entitled to a deduction for depreciation with respect to personal property leased to tenant-stockholders. Congress also believed that the provision of prior law which, in effect, required that most tenant-stockholders of cooperative housing corporations be individuals should be revised so that banks and other lending institutions which lend money for the purchase of stock in these corporations can hold stock obtained through foreclosure for a limited period of time.

Explanation of provisions

Under the Act, a qualified homeowners' association (that is, a condominium management association or a residential real estate association) generally may elect to be treated as a tax-exempt organization. If an election is made, the association is not to be taxed on any "exempt function income".[3] Exempt function income means membership dues, fees, and assessments received from persons who own residential units in the particular condominium or subdivision and who are members of the association.[4]

The association is to be taxed, however, on any net income which is not exempt function income. For example, any interest earned on amounts set aside in a sinking fund for future improvements is taxable. Similarly, any amount paid by persons who are not members of the association for use of the association's facilities, such as tennis courts, swimming pools, golf courses, etc., would be taxable. Further, any amount paid by members for special use of the association's facilities, the use of which would not be available to all the members as a result of having paid the membership dues, fees, or assessments required to be paid by all members of the association, would be taxable. For example, if the membership dues, fees, or assessments do not entitle a member to use the association's party room or to use the swimming pool after a certain time period, then amounts paid for this use are taxable to the association. Deductions are allowed for expenses directly connected with the production of taxable income.

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[3] If the provisions of the Act are not met (or an election is not made to be treated as tax-exempt), a homeowners' association is to continue to be treated as it was under prior law.

[4] Assessments for the current management, maintenance and care of association property are to be exempt from tax as exempt function income. Also, as under prior law, assessments to finance current or future capital improvements to association property are capital contributions and are not subject to tax.

The Act provides a $100 deduction against taxable income so that associations with only a minimal amount of taxable income will not be subject to tax. However, a net operating loss deduction is not allowed, and the special deductions for corporations (such as the dividends received deduction) are not allowed.

A homeowners' association is taxed as a corporation on its taxable income.[5] The tax rate to be applied is the corporate rate without the surtax exemption. If the association has net long-term capital gain, the capital gain portion of the taxable income is taxed at a 30-percent rate.

Generally, two different types of homeowners' associations are treated as tax-exempt under the Act: condominium management associations and residential real estate management associations.

In order to qualify for this treatment under the Act, a homeowners' association must meet several common requirements. First, the association must be organized and operated to provide for the management, maintenance, and care of association property. Although the property maintained by the association is generally property owned by the association and available for common use by all the members or property owned by a governmental unit and available for the common benefit of residents of the unit, the association may maintain areas that are privately owned but affect the overall appearance and structure of the project. For example, in a condominium project, the condominium association may enforce covenants with regard to the appearance of the individual units and may maintain the exterior walls and roof of the individual condominium units. Although the property maintained is private, its appearance may directly affect the condition of the entire project. As a consequence, the exterior walls and roofs may be considered as association property which may be maintained by a qualified association. However, for this property to qualify as association property, it is intended that there be a covenant of appearance applying on the same basis to all property in the project, that there be pro rata annual mandatory assessments for maintaining this property on all members of the association, and that membership in the association be compulsorily tied to every person's ownership of property in the project.

Second, a homeowners' association must meet certain income and expenditure tests. Generally, these tests are to insure that the primary activity of the association is to manage, maintain, and improve association property, and that the owner-members of the association finance these activities.

Under the Act, at least 60 percent of the association's gross income must consist solely of membership dues, fees, or assessments from owners of residential units or owners of residences or residential lots, (exempt function income), as the case may be.

For this purpose, amounts that qualify for the 60-percent test are not to include assessments for capital improvements which otherwise would not be treated as income to the association but would be treated as capital contributions. Qualified income includes fixed annual membership dues or fees and assessments that vary depending upon the

[5] Every homeowners' association which elects to be taxed under these provisions and has taxable income is to file an annual return.

need of the association to pay for acquisition or construction of, and management, maintenance, improvements, real property taxes, etc., on the common property.

Qualifying receipts must be derived from members in the capacity of owner-members and not in the capacity as customers for services provided by the association. For example, payments by owner-members for maid service, secretarial service, cleaning, etc., do not qualify.

Qualified income does not include assessments that are related to particular work done on the privately-owned property of an individual's residence, etc., since this is more in the nature of providing services in the course of a trade or business than in the nature of a common activity undertaken by a collective group of owners. However, pro rata assessments which are paid by all owners in the project and are used for maintaining exterior walls and roofs will be qualified income if the conditions described above for treating this property as association property are met. To the extent that a condominium association or subdivision association owns mortgaged property, assessments to pay principal and interest on the mortgage debt will be qualified income for the 60-percent test.

Amounts received from persons who are not owners of residential property in the project, or who are otherwise not association members, are not exempt function and thus are not includable in the numerator of the fraction used to determine whether the 60-percent income test is met, but are includable in income of the association.

In addition to the income test, the Act provides an expenditure test. Under this test, at least 90 percent of all of the annual expenditures of the homeowners' association must be to acquire, construct, manage, maintain, and care for, or improve, association property. Qualifying expenditures include both current and capital expenditures on association property. For example, qualifying expenditures include salaries paid to an association manager or secretary and expenses of maintaining association news-letters. Qualifying expenditures will also include expenses for gardening, paving, street signs, security personnel, property taxes assessed on property owned by the association, and current operating expenses of tennis courts, swimming pools, recreation rooms and halls, etc. In addition, expenses for replacement of common buildings, equipment and facilities such as replacement of heating, air conditioning, elevators, etc., will qualify. However, as discussed above, expenditures on privately owned property—as opposed to common property—are to qualify only in the limited situation of repair of exterior walls and roofs where the walls and roofs qualify as association property. Since association property includes property owned by a governmental unit for the common benefit of residents of that unit, qualifying expenditures include funds which the association may expend on roads or common utility facilities which are owned by a governmental unit, such as a county or municipal utility district.

Investments or transfers of funds to be held to meet future costs are not to be taken into account as expenditures. For example, transfers to a sinking fund account for the replacement of a roof would not qualify as expenditures for the 90-minute test.

Following existing law with respect to other exempt organizations generally, the Act also provides that no part of the net earnings of an exempt homeowners' association may inure to the benefit of any private shareholder or individual. To the extent that members receive a benefit from the general maintenance, etc., of association property, this benefit would not constitute inurement. A rebate to members of excess assessments would generally not constitute inurement. However, if an association pays rebates from its net earnings, such payment will constitute inurement.

In addition to the general requirements, in the case of a condominium management association, substantially all of the dwelling units must be used as residences. Similarly, in the case of a residential real estate management association, substantially all the lots or buildings must be used by individuals for residences.[6]

The Act does not allow cooperative housing corporations to elect to be treated as subject to the new rules applicable to condominium managements associations and residential real estate management associations because cooperative housing corporations have a long history of being treated as taxable organizations. Instead, the Act clarifies prior law (sec. 216(c)) to insure that a cooperative housing corporation is entitled to a deduction for depreciation with respect to property it leases to a tenant-stockholder even through such tenant-stockholder may be entitled (under sec. 216(c)) to depreciate his stock in the cooperative housing corporation to the extent such stock is related to a proprietary lease or right of tenancy which is used by the tenant-stockholder in a trade or business or for the production of income. Congress believes that when section 216(c) was added to the Code in 1962, Congress did not intend the allowance for depreciation on such stock to affect the availability to the cooperative housing corporation of depreciation deductions on property leased to tenant-stockholders. However, the Tax Court in one case, *Park Place, Inc.*, 57 T.C. 767 (1972), reached a contrary conclusion, and the Act adds specific statutory language to reflect what Congress believes to be the appropriate interpretation of section 216(c) under prior law.[7]

Congress does not believe that a clarification of the rules relating to the cooperative housing corporation's ability to take depreciation deductions with respect to property leased to tenant-stockholders will create tax avoidance possibilities because the provisions of existing law (sec. 277) generally prevent nonexempt membership organizations from offsetting nonmember income with losses from dealings with members.

The Act also modifies the prior law rule that a tenant-stockholder in a cooperative housing corporation must be an individual by permitting a bank or other lending institution which obtains stock in a cooperative housing corporation through foreclosure to be treated as a tenant-stockholder for up to three years after the date of acquisition.

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[6] It is intended that if a lot is zoned for residential use it will be treated as being used for residential purposes as long as a nonresidential improvement has not begun on the lot. It is also intended that land uses which are auxiliary to residential use (such as parking spaces, swimming pools, tennis courts, schools, fire stations, libraries, etc.) are to be considered as residential uses.

[7] This provision is not intended to affect the deductibility by a cooperative housing corporation of real estate taxes and interest referred to in section 216(a). See Rev. Rul. 62–178, 1962–2 C.B. 78.

Effective date

These provisions generally apply to payments received after December 31, 1973, in taxable years ending after such date. However, the provision relating to foreclosures by lending institutions applies to stock acquired after the date of enactment (October 4, 1976).

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

2. Treatment of Certain Crop Disaster Payments (sec. 2102 of the Act and sec. 451(d) of the Code)

Prior law

Insurance proceeds received by a taxpayer as a result of destruction or damage to crops may be included in income in the taxable year following the year of their receipt, if it can be established that the income from the crops which were destroyed or damaged would otherwise have been properly included in income in the following taxable year (sec. 451(d)). The reason for this provision is to avoid the problem of doubling up income for a cash basis farmer by including crop insurance proceeds in income in the taxable year they are received rather than in the taxable year following the year of receipt, which would generally be the pattern of income receipt from sales of crops.

Because of this doubling up of income in the year of receipt, the farmer would have only deductions and no income to report in the next year and therefore would be likely to have a net operating loss to carry back and offset against income in the prior year. However, the farmer in such cases was faced with the payment of tax and subsequent filing for a refund. He also loses the benefit of his personal exemption and his standard or itemized deductions in the year of loss.

Reasons for change

The Agriculture and Consumer Protection Act of 1973 (Public Law 93–86, which amended the Agricultural Act of 1949) provides that specified payments by the Department of Agriculture are to be made to farmers in the event that they are either prevented from planting certain crops because of drought, flood, or other natural disaster or condition or, because of such a disaster or condition, the total quantity of certain planted crops which the farmers are able to harvest on any farm is less than 66⅔ percent of the projected yield of the crop. The crops covered by these disaster payments are wheat, corn, grain, sorghum, barley, and upland cotton. Premium payments are not required for this protection.

The Service ruled that the provisions of prior law were not applicable to the payments provided to the farmers who are covered by the Agriculture and Consumer Protection Act of 1973 on the grounds that the proceeds are not insurance proceeds since no premium was paid by the farmer. As a result of the Service's position with respect to the payments received by a taxpayer under the Agriculture and Consumer Protection Act of 1973, these payments had to be reported as taxable income in the year of receipt and not in the year in which the income from the sale of the crops would normally be reported.

Explanation of provision

The Act provides that in the case of a taxpayer using the cash receipts and disbursements method of accounting, certain payments received pursuant to the Agricultural Act of 1949, as amended is to be included in the taxable income of the taxpayer, at his election, in the year in which the income normally received from the crops would have been reported. This provision is to apply only to such payments received as a result of (1) destruction or damage to crops caused by drought, flood or any other natural disaster, or (2) the inability to plant crops because of such a natural disaster.

Effective date

This provision applies to payments received after December 31, 1973, in taxable years ending after such date.

Revenue effect

This provision will reduce budget receipts by $48 million in fiscal year 1977, $42 million in fiscal year 1978, and $42 million in fiscal year 1981.

3. Tax Treatment in the Case of Certain 1972 Disaster Loans (sec. 2103 of the Act)

Taxpayers are generally allowed to deduct their losses sustained during the taxable year, including losses attributable to fire, storm and other casualty, to the extent that such losses are not compensated for by insurance or otherwise.[1] In the case of any loss attributable to a major disaster which occurred in an area authorized by the President to receive disaster relief, a special rule allows the loss, at the election of the taxpayer, to be deducted on the return for the year immediately preceding the year of the disaster (that is, the loss may be deducted on the return which is generally filed in the year in which the disaster occurs). In a case where a deduction resulting from a loss is claimed in one year, and compensation is paid with respect to that loss in a later year, the amount of compensation is generally required to be taken into income by the taxpayer under the tax benefit theory.

Reasons for change

Certain cases arising in the past have come to the attention of the Congress in which individuals who were hard hit by disasters, such as a flood, claimed a deduction with respect to the disasters, unaware, in many cases, that they might later receive compensation, or partial compensation, for their loss. In some instances, the compensation may be received in a year for which the taxpayer is in a higher tax bracket than he was in for the year for which the disaster loss deduction was claimed. As a result, the taxpayer may be required to pay more tax, with respect to the compensation or reimbursement, than would have been owing if he had not claimed the deduction in the first place.

Explanation of provision

The Act provides that, under certain circumstances, in the case of a loss attributable to a disaster which occurred in 1972, in an area

[1] Individuals generally are allowed to deduct their losses of property (not connected with their trade or business) only to the extent that the loss exceeds $100: losses attributable to an individual's business are fully deductible.

designated by the President as a disaster relief area, the tax on the first $5,000 of compensation received with respect to that loss is not to exceed the tax which would have been payable if the $5,000 (or lesser) deduction had not been claimed. This treatment applies only if the taxpayer elects to come under these provisions, in a time and manner to be prescribed in regulations and must meet certain conditions.

In order for the taxpayer to elect the benefits of this provision, he must have suffered a disaster loss for the year 1972, and to be fully eligible under this provision his adjusted gross income for the year in which he claimed the disaster loss as a deduction (either 1972 or 1971, as the case may be) cannot have exceeded $15,000 ($7,500 in the case of a married individual filing a separate return). In those cases where an individual who is otherwise eligible under this provision has adjusted gross income in excess of $15,000 (or $7,500, whichever applies), the $5,000 limit is to be reduced dollar-for-dollar to the extent his adjusted gross income exceeds $15,000.

The election may be made with respect to up to $5,000 of compensation which is paid in a year after the year for which the loss deduction is claimed and which results either (1) from the forgiveness or cancellation of a disaster loan under section 7 of the Small Business Act or an emergency loan under subtitle C of the Consolidated Farm and Rural Development Act, or (2) from a payment made to the taxpayer in settlement of a tort claim which the taxpayer had against another person.

Any compensation or reimbursement in excess of the $5,000 limitation must be taken into income by the taxpayer for the year in which the payment is received.

If these conditions are satisfied, and the taxpayer makes the election, as provided for under the Act, then the tax with respect to the compensation or reimbursement is not to exceed the tax which would have been payable if the loss had not been claimed as a deduction for 1971 or 1972 (as the case may be). For example, if a $5,000 deduction was claimed for 1972 which had the effect of reducing the taxpayer's taxable income for that year to $5,000 and the taxpayer was a married taxpayer who filed a joint return for that year, the tax liability with respect to $5,000 of compensation received in a later year from disaster loan forgiveness or settlement of tort claim liability is not to exceed the marginal rate on the difference between $5,000 and $10,000 of taxable income.

In addition, since many of the taxpayers affected by this provision may still be suffering hardships from the effects of the flood, the Act provides that any tax with respect to this $5,000 amount which was still unpaid on October 1, 1975, may be paid in three equal annual installments, with the first such installment due and payable on April 15, 1977. Also, under the amendment, no interest on any deficiency with respect to this $5,000 amount is to be payable for any period prior to April 16, 1977, and no interest is to be payable with respect to any installment payment (made under this rule as just outlined) before the due date for that installment.

Effective date

This provision shall apply to payments received after 1971 in connection with a 1972 disaster loss, even if the year involved is closed, provided a claim for refund is made within one year of the date of enactment (October 4, 1976).

Revenue effect

This provision will reduce revenue by $60 million in fiscal year 1977, $15 million in fiscal year 1978, and $15 million in fiscal year 1979, with no revenue loss thereafter.

4. Tax Treatment of Certain Debts Owed by Political Parties to Accrual Basis Taxpayers (sec. 2104 of the Act and sec. 271 of the Code)

Prior Law

Under prior law, any deduction generally allowable for bad debts (sec. 166) or for worthless securities (sec. 165(g)) was not allowed for a worthless debt owned by a political party. This provision applied to all taxpayers other than a bank (as defined in sec. 581), but where the debt arose out of the sale of goods or services, the provision affected only taxpayers utilizing the accrual method of accounting (because these taxpayers would have taken into income the receipts which give rise to the debt).

The provision defined political parties to include all committees of a political party and all committees, associations, or other organizations which accept contributions or make expenditures on behalf of any individual in any Federal, State or local election.

Reasons for change

The disallowance of a bad debt deduction for debts owed by political parties caused a substantial hardship for taxpayers in the business of providing goods or services (such as polling, media, or organizational services) to political campaigns and candidates. The business of providing these types of services has grown substantially in recent years. As a result, a significant number of taxpayers have been placed in a less favorable position than taxpayers in virtually any other business because they have not been able to deduct bad debts which arise in the ordinary course of their business.

The provision disallowing any bad debt deduction was originally enacted to prevent tax deductions for concealed campaign contributions. However, since, in the case of the sale of goods or services, the deduction was allowed only if the amount of gross receipts which gave rise to the debt was included in taxable income, the effect of the provision was to tax these individuals on income which they never received.

Furthermore, since prior law did not affect cash basis taxpayers who sell services for political campaigns because in that case no amount is taken into income, the provision discriminated against taxpayers whose business differs from others only in that they were on the accrual method of accounting.

Explanation of provision

The Act adds an exception to the provision disallowing a deduction for bad debts owed by political parties (sec. 271). The exception applies only to taxpayers who use the accrual method of accounting. These taxpayers are to be allowed a bad debt deduction with respect to debts which are accrued as a receivable in a *bona fide* sale of goods or services in the ordinary course of their trade or business. Thus, the receipts giving rise to the debt must have been taken into income in order for the deduction to be obtained.

The Act limits this exception to those cases in which 30 percent of all of the receivables accrued in the ordinary course of all of the trades or businesses of the taxpayer are due from political parties. Thus, the exception is limited to those taxpayers whose sales to political parties (including political campaigns and candidates) constitute a major portion of their trades or businesses. In determining the amount required to meet the 30 percent rule, all of the taxpayer's trades and businesses are to be considered. Thus, in the case of an individual, every trade or business which the taxpayer controls is to be aggregated for purposes of this test. In the case of a taxpayer which is a corporation, every trade and business of all corporations under common ownership with the taxpayer is to be aggregated.

The bad debt deduction is to be allowed only if the taxpayer has made substantial continuing efforts to collect on the debt. Thus, a taxpayer must make good faith efforts over a period of time to collect the debt and must be able to document those efforts. However, it is not intended that a taxpayer is required in any case to file a lawsuit against the debtor in order to be determined to have made substantial continuing efforts.

The Congress affirmed that the provision of prior law was not intended to apply to taxpayers whose primary business is to provide goods or services to political parties. The changes made by the Act thus reflect Congress' original intent in enacting prior law.

Effective date

This provision is to apply to taxable years beginning after December 31, 1975.

Revenue effect

It is anticipated that this provision will produce a negligible loss of revenues.

5. Tax-Exempt Bonds for Student Loans (Sec. 2105 of the Act and sec. 103 of the Code)

Prior law

Under section 103(a) of the Code, interest paid on certain governmental obligations is exempt from Federal income tax. These obligations are those of the States and their political subdivisions, and of certain corporations organized under an Act of Congress as instrumentalities of the United States. However, interest on such governmental obligations (with a minor exception) is not exempt from taxation if a major portion of the proceeds can be reasonably expected to be used, directly or indirectly, to purchase nonexempt securities or obligations that can reasonably be expected to produce a higher yield over the term of the issue than the yield on the governmental obligations. These governmental obligations, which are subject to Federal taxation, are called "arbitrage bonds." In addition, governmental obligations whose proceeds are expected to be used to replace such nonexempt governmental obligations are themselves subject to tax.

However, governmental obligations are not treated as arbitrage bonds merely because their proceeds are temporarily invested in obligations paying a higher yield until those proceeds can be put to their intended purpose. In addition, obligations are not arbitrage bonds simply because their proceeds are invested in obligations paying a higher yield that are a part of a reasonably required reserve or replacement fund.

Reasons for change

Congress is aware that groups in at least one State are attempting to develop a student loan program for students desiring a college education. Since political subdivisions in the State apparently do not have the governmental authority to issue bonds to finance their own student loan programs, not-for-profit corporations in that State are being organized to finance the needed student loan programs. These corporations, however, faced considerable obstacles because the interest on bonds they wished to issue to finance student loans may have been taxable under prior law. The corporations are not political subdivisions of the State and could not be treated under the Treasury regulations as acting "on behalf of" the State or its political subdivisions. Even if they were described in section 103(a), these obligations might not have been exempt because they might have been arbitrage bonds under section 103(c).

Under the Emergency Insured Student Loan Act of 1969, the Commissioner of Education (of the Department of Health, Education, and Welfare) is authorized to provide incentive payments to institutions providing student loans. Although the maximum rate of interest to be paid by students on their loans is now set at seven percent, this yield, together with the incentive payments received by the institution making the loan from the Commissioner of Education, would constitute a yield that could be higher than the maximum yield the corporations believe they would be able to pay on their bonds if they are to cover administrative expenses and maintain a solvent loan program. Consequently, their bonds, under prior law, would be considered arbitrage bonds and not entitled to tax exemption.

Congress believes it is appropriate to treat the obligations of these corporations providing student loans in the same manner as if the State had issued the bonds directly.

Explanation of provision

This provision adds to the list of exempt obligations described in section 103(a) those obligations of not-for-profit corporations organized by, or requested to act by, a State or a political subdivision of a State (or of a possession of the United States), solely to acquire student loan notes incurred under the Higher Education Act of 1965. The entire income of these corporations (after payment of expenses and provision for debt service requirements) must accrue to the State or political subdivision, or be required to be used to purchase additional student loan notes. The obligations are to be called "Qualified Scholarship Funding Bonds."

As a result of this provision, organizations which wish to maintain student loan programs will have statutory authority to issue tax-exempt bonds to finance their operations.

In addition, a provision is added to make it clear that the student loan incentive payments made by the Commissioner of Education under the Emergency Insured Student Loan Act of 1969 are not to be taken into account in determining whether the yield on the student loan notes is higher than the yield on the bonds issued to finance the student loan program. As a result, bonds issued to finance student loan programs would be expected to be able to avoid arbitrage bond classification.

Effective date

These provisions would apply to obligations issued on or after the date of enactment. Thus, the interest on bonds issued on or after the date of enactment in order to finance student loan programs to enable students to attend institutions of higher learning may be exempt from Federal taxation if the requirements of the amendment are met.

Revenue effect

It is estimated that these provisions will reduce the revenues by less than $5 million annually.

6. Personal Holding Company Amendments (Sec. 2106 of the Act and Sec. 543 of the Code)

Prior law

A corporation which is a personal holding company is taxed on its undistributed personal holding company income at a rate of 70 percent (sec. 541). A corporation is a personal holding company where five or fewer individuals own more than 50 percent in value of its outstanding stock and at least 60 percent of the corporation's adjusted ordinary gross income comes from certain types of income.

Royalties (other than mineral, oil or gas royalties and copyright royalties) received by a corporation are personal holding company income, regardless of how much income of other types the corporation may have (sec. 543(a)(1)). "Royalties" include amounts received for a license to use trade brands, secret processes, franchises and similar intangible property.

In general, rental income received from persons other than major shareholders is treated as personal holding company income unless such rent comprises 50 percent or more of the corporation's adjusted ordinary gross income and, if the company has a substantial amount of other types of personal holding company income, it distributes such income (sec. 543(a)(2)).

Under a separate rule of prior law (sec. 543(a)(6)), rents received by a corporation from leasing corporate "property" to a 25-percent or greater shareholder were personal holding company income, but only if over 10 percent of the company's total income came from other types of personal holding company income. In Rev. Rul. 71-596, 1971-2 Cum. Bull. 242, the IRS ruled that a company's income from licensing a major shareholder to make and sell a secret process was governed by the "royalty" rule rather than by the "shareholder rent" rule. In 1975 the U.S. Court of Claims also held in *Montgomery Coca-Cola Bottling Co.* v. *United States*, 75-1 USTC para. 9291, 35 AFTR 2d

75–1081 (Ct. Cl. 1975), that the royalty rule rather than the shareholder rent rule applies to income from a license of intangible property. Consequently, the full license payments of this kind have been held to be personal holding company income in the category of "royalties" (sec. 543(a)(1)), regardless of how much income of other types the corporation may have.

Reasons for change

Broadly stated, the rationale for the treatment of rental income generally under the personal holding company rules is that if the rents received for the use of corporate property are over half of the corporation's total income, the company is engaged in an active real estate business and generally ought not be treated as being used merely to deflect passive income away from its shareholders. Similarly, rental income received from shareholders has generally not been treated as personal holding company income unless the income is used to shelter appreciable amounts of other investment income. However, the statute has long treated income from royalties received by a corporation for the use of intangible property (except for certain specially treated kinds of royalties) as personal holding company income regardless of the nature or source of the company's other income. Typically, such royalties come from third-person payors unrelated to the corporation, i.e., persons who are not its shareholders. The issue is whether more favorable treatment under sec. 543(a)(6) should be accorded to royalty income received by a corporation from one or more of its major shareholders than is accorded the same type of income when it is received from outsiders. Congress concluded that no sound justification exists for such a distinction.

On the other hand, it has come to Congress' attention that in some situations a corporation may be given ownership of licenses and other intangible property in order to protect the license through the perpetual life of the corporation, although the shareholders still desire to conduct a trade or business in which they use the license. Consequently, the corporation will license the contract right to one or more of its shareholders who will use the contract right in conducting his or their separate business. In this type of situation, Congress believes that if tangible and intangible property are together leased and licensed to a 25 percent or greater shareholder and used by him in conducting an active trade or business, the company's income from the license (although treated as royalty income under section 543 (a)(1) by reason of the Act) should not count as a type of income which, under the 10 percent test of section 543(a)(6), could cause income from the tangible property to be treated as personal holding company income.

Explanation of provision

The Act amends the shareholder rent rule in section 543(a)(6) to apply that rule only to tangible property leased by a corporation to one or more of its major shareholders. Congress intends, however, that even if income received by the corporation from renting tangible property to a major shareholder qualifies under the tests in section 543(a)(6) as nonpersonal holding company income, such income must also be treated as rental income for purposes of the general rent rules in section 543(a)(2) of present law and, as such, must be separately tested under those rules. On the other hand, if income from a lease of tangible property constitutes personal holding company income pursuant to the tests of section 543(a)(6), it will be personal holding company income even if it could qualify not to be so treated under the general rent rules of section 543(a)(2) (by reason, for example, of satisfying the dividend distribution requirements of that paragraph). In order not to constitute personal holding company income, therefore, rents from tangible property must satisfy the applicable rules of both paragraphs (2) and (6) of section 543(a).[1]

The Act also makes clear, in effect, that income from the use of secret processes, trade brands and other intangible property (but not including certain specially-treated royalties), are always to be treated as personal holding company income under the general royalty rule (sec. 543(a)(1)), regardless of whether they are received from a shareholder of the corporation or from an unrelated third party.

The Act provides, however, that solely for purposes of determining under section 543(a)(6), as amended, whether over 10 percent of the corporation's income consists of personal holding company income, income from a license of intangible property to a 25 percent or greater shareholder is not to be treated as personal holding company income, but only if the corporation owns a substantial part of the tangible property used in connection with the intangible property and leases to the shareholder both kinds of property, all of which he uses to conduct an active trade or business. If these conditions are not satisfied, compensation received for the use of intangibles is included among the other types of personal holding company income of the company for purposes of applying the 10 percent test under section 543(a)(6) to determine whether income from tangible property is to be treated as personal holding company income under that paragraph.

Effective date

These changes made in section 543 of the Code apply to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will not have a significant effect on tax revenues.

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[1] Rental income received by a corporation from the use of tangible property by a 25-percent or greater shareholder may satisfy the requirements under section 543(a)(2) in order to escape treatment as personal holding company income, but such income may still be treated as personal holding company income by reason of the rules of section 543(a)(6).

Conversely, rent received from shareholders can "pass" section 543(a)(6) but still "fail" the tests in section 543(a)(2), with the result that such income will constitute personal holding company income. To illustrate this latter situation, assume that a corporation receives $100 in rents (for tangible property) from a major shareholder and $6 in dividend income from portfolio investments and that the company expends $95 in deductions for depreciation, interest, and property taxes relating to the rental property. On these facts, the rental income is not personal holding company income under section 543(a)(6) because less than 10 percent ($6/$106) of the company's ordinary gross income is derived from other personal holding company income. However, the rental income must also be tested under the general rent rule of section 543(a)(2). So tested, the rent income is personal holding company income because the 50 percent safe haven test (in sec. 543(a)(2)(A) is not satisfied; the adjusted income from rents ($5) is less than 50 percent of the company's adjusted ordinary gross income ($11).

7. Work Incentive (WIN) and Federal Welfare Recipient Employment Incentive Tax Credits (sec. 2107 of the Act and sec. 50 (A) and (B) of the Code)

Prior law

Under prior law, a work incentive (WIN) credit equal to 20 percent of the wages paid during the first 12 months of employment to qualified AFDC recipients was available to employers engaged in a trade or business who hire such employees. Qualified participants were certified by the local WIN agency.

The amount of the credit available in any year was limited to the first $25,000 of tax plus one-half of tax liability in excess of $25,000. The credit was not available in the case of an employee who ceased to work for the original employer unless the employee voluntarily quit, became disabled, or was fired for misconduct before two years had passed.

Under the Federal welfare recipient employment incentive tax credit (welfare recipient tax credit), all private employers including those who provide employment for private household workers were eligible for the credit. Qualified employees were AFDC recipients who had received benefits for 90 days. The credit was essentially the same as the WIN credit: 20 percent of eligible wages, except that there was a limit of $5,000 a year on the annual eligible wages for nonbusiness employees; the same overall credit limit of $25,000 of tax plus one-half of the excess also applied. The State or local welfare agency certified recipients as qualified. This provision expired on July 1, 1976.

Reasons for change

WIN tax credit.—The Congress was concerned that the WIN tax credit is not being used to the extent anticipated. One aspect of the WIN tax credit which has been cited as a major reason why employers are not using the credit is the requirement for repayment of the credit by the employer if he terminates the employment without cause before the end of the second year. A significant percentage of the amounts which have been earned as tax credits have reportedly been recovered by the IRS for this reason. It has been suggested to the Congress that the removal or modification of this recapture provision would encourage greater use of the tax credit and would make it consistent with the welfare recipient tax credit, which has no recapture provision.

Another suggestion for promoting greater use of the credit has been to raise the dollar limitations on the amount which any single employer can claim. Treasury statistics indicate that about 63 percent of the amount claimed for WIN is by corporations with assets in excess of $250 million. These larger corporations might be expected to make greater use of the credit by hiring more welfare recipients if there were a higher limit on the amount which could be claimed.

Welfare recipient tax credit.—The welfare tax credit, which became effective March 29, 1975 (as part of the Tax Reduction Act of 1975) and expired July 1, 1976, has been in effect for too brief a time to judge its effectiveness. Early statistics show, however, that there has been virtually no use made of the provision thus far. Part of the problem is

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that it is still unknown and employers have not yet had any experience with it. In order to give it a fairer test, it would seem desirable to extend the expiration date into the future. This would assure not only that there would be sufficient opportunity to make employers aware of its advantages, but also that it could be tested over time for its usefulness as a means of getting welfare recipients moved into jobs.

Because the welfare tax credit was originally passed with a 15-month limit, there was no reason to provide for a limit to the period of time for which the credit could be claimed for any one employee. However, when the credit is extended for several years such a limit becomes necessary. It is difficult to justify giving an employer a tax advantage for an indefinite period into the future for each welfare recipient he may hire. One year would seem to be adequate time for the employer-employee relationship to have become well enough established to make termination of the credit with regard to an employee justifiable and without undue risk to the employee. This would be consistent with the WIN tax credit provision which also gives a credit only for the first 12 months of employment.

Explanation of provision

The Act makes several modifications to both the WIN and welfare tax credits to make them more effective.

The Act makes three changes in the WIN credit. First, the credit is available from the date of hiring if employment is not terminated without cause before the end of six months. Second, an additional exemption is added to the recapture rules so that there would be no recapture of the credit if the employee were laid off due to a substantial reduction in business. Third, the limit on the credit is doubled from $25,000 to $50,000 plus one-half of the excess over $50,000.

The Act also made three changes in the welfare recipient tax credit. First, the expiration date is extended from July 1, 1976, to January 1, 1980. Second, a limit of 12 months for which the wages of any one employee would be eligible for the credit is provided. Third, the WIN agencies can also certify eligibility for the welfare recipient tax credit.

Effective date

These changes became effective upon the date of enactment of this Act (October 4, 1976).

Revenue effect

This provision will reduce budget receipts by $3 million in fiscal year 1977, $7 million in fiscal year 1978, and $9 million in fiscal year 1981.

8. Excise Tax on Parts for Light-Duty Trucks (sec. 2108 of the bill and sec. 6416(b)(2) of the Code)

Prior law

The Revenue Act of 1971 repealed the 10-percent excise tax on light-duty trucks and buses (those with gross vehicle weight of 10,000 pounds or less). As a result, truck and bus parts and accessories sold by the vehicle manufacturer as part of (or in connection with the sale thereof) a light-duty truck or bus are not subject to tax—neither the 10-percent tax that used to be imposed on the vehicle, nor the 8-percent tax on truck parts and accessories. (Both the 10-percent and 8-percent taxes are scheduled to be reduced to 5-percent for sales on or after October 1, 1979). Also, if a truck parts or accessories manufacturer sells parts or accessories to a manufacturer of light-duty trucks for use in "further manufacture" of those trucks, the parts and accessories are not subject to tax. However, under prior law, if the truck parts manufacturer sold parts separate from the light-duty trucks and the installation of those parts by a retail truck dealer technically was not "further manufacture" of the trucks, then the manufacturer's excise tax of 8 percent applied. This was so even though the part or accessory was sold to the retail customer at the same time he purchased the tax-exempt light-duty truck or bus.

Reasons for change

It appeared inequitable to the Congress to tax a truck part or accessory when purchased by a truck dealer as a separate item where it is sold on or in connection with the retail sale of a light-duty truck, while exempting such parts or accessories if they were included with the truck as delivered from the manufacturer to the dealer. The provision removes the discriminatory treatment of such parts and accessories.

Explanation of provision

The Act provides that the 8-percent manufacturer's excise tax on truck parts and accessories is to be refunded or credited to the manufacturer in the case of any part or accessory sold on or in connection with the first retail sale of a light-duty truck. Thus, those parts and accessories are to be effectively treated the same as the parts and accessories that actually are a part of the tax-exempt truck as delivered from the manufacturer. The credit or refund is not intended to cover replacement parts even if ordered at the time of the purchase of the truck, but only those parts and accessories which are to have original use on the purchased truck or bus.

Effective date

The amendments made by this section apply to parts and accessories sold after the date of enactment (after October 4, 1976).

Revenue effect

This amendment is estimated to result in annual revenue losses of about $3 million. This revenue would otherwise go into the Highway Trust Fund (through September 30, 1979).

9. Exclusion From Manfacturers' Excise Tax for Certain Articles Resold After Modification (sec. 2109 of the Act and sec. 4063 of the Code)

Prior law

A 10-percent manufacturers' excise tax is imposed on sales or resales of bodies and chassis for heavy trucks, buses not used for mass transport, heavy trailers and semitrailers, and highway tractors (other than for light-duty trucks or buses—those with gross vehicle weight of 10,000 pounds or less).[1] An 8-percent tax is imposed on sales or re-

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[1] The rate of tax is to be reduced to 5 percent for sales on or after October 1, 1979 (sec. 4061(a)(1) of the Code).

sales of parts or accessories for trucks and buses (sec. 4061(b)).[2] The same taxes are imposed upon a manufacturer, producer, or importer of an article who uses that article himself and does not sell it (sec. 4218).

Reasons for change

Persons who obtain bodies or chassis and certain parts or accessories from different manufacturers and combine them are considered "further manufacturers" and must pay a 10-percent tax on the resale of the combined article, after credit for tax previously paid by the original manufacturers. The same additional tax must be paid by the "further manufacturer" who uses the combined article himself rather than resells it. On the other hand, persons who buy the entire combination from a single manufacturer do not pay a manufacturers' excise tax on a resale or personal use even if they themselves must combine the articles. This discriminatory tax treatment results in a competitive disadvantage to the taxpayer who combines the articles from different manufacturers since he must pay an additional tax on his profit and on his cost of assembling the item (and, if the article is resold, the cost of marketing the item).

Explanation of provision

Under the Act, a resale or use of an article subject to the 10-percent manufacturers' excise tax is not to be taxed merely because the taxpayer reselling or using the article combined it with a coupling device, wrecker crane, loading and unloading equipment, aerial ladder or tower, snow and ice control equipment, earthmoving, excavation and construction equipment, spreader, sleeper cab, cab shield, or wood or metal floor. This provision will remove the discriminatory tax treatment operating against the taxpayer who combines one of these articles with an article from a different manufacturer on which the 10-percent tax has been paid.

Effective date

This provision applies to resales and uses on or after the date of enactment of the Act, October 4, 1976.

Revenue effect

This provision is expected to result in a revenue loss of less than $5 million annually, which would otherwise go into the Highway Trust Fund (through September 30, 1979).

10. Franchise Transfers (sec. 2110 of the Act and sec. 751 of the Code)

Prior law

The Code (sec. 1253) provides generally that the transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

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[2] This tax is also scheduled to be reduced to 5 percent for sales on or after October 1, 1979 (sec. 4061(b)).

Under prior law, gain which would be treated as ordinary income pursuant to section 1253 (unlike gain which would be treated as ordinary income under any other sections of the Code, e.g., sections 1245, 1250, 1251, and 1252) was not treated as an "unrealized receivable" of a partnership which would have the effect of causing ordinary income upon certain partnership distributions, payments in liquidation of a partnership interest, or sales or other dispositions of partnership interests.

Reasons for change

Congress believed that partnership transactions of the type described above should, in situations where a franchise, trademark or trade name is involved, be subject to ordinary income treatment as in cases in which, if a partnership were not involved, ordinary income would be recognized. In general, failure to deal with partnership transactions in this manner would have allowed taxpayers to avoid ordinary income treatment by restructuring transactions to involve the formation of a partnership by the franchisor and the franchisee followed by a sale or liquidation of the franchisor's partnership interest.

Explanation of provision

The Act provides that, with respect to certain partnership distributions, sales of partnership interests, and distributions in liquidation of partnership interests, the term "unrealized receivable" is to include the ordinary income element which would have been recognized had the partnership directly transferred a franchise, trademark, or trade name.

Effective date

This provision applies to transactions occurring after December 31, 1976, in taxable years ending after that date.

Revenue effect

It is estimated that this provision will have no significant revenue effect in fiscal year 1977 and future years.

11. Employer's Duties To Keep Records and To Report Tips (Sec. 2111 of the Act)

Prior law

The tax law (sec. 6053(a) of the Code) requires employees to report all tips received (including charge account tips) to their employers, usually on a monthly basis. The tips required to be reported to employers are tips received and retained after any tip-splitting (such as by waiters and waitresses with busboys) or tip-pooling (such as by a waiter with other waiters). Section 6051(a) requires employers to report on IRS Forms (W-2) as wages subject to income tax withholding and Federal Insurance Contributions Act (FICA) withholding only the tips actually reported to them by their employees pursuant to section 6053(a).

Section 6041(a) requires every employer of an employee earning $600 or more yearly to report the total of that employee's earnings to the IRS. As a result, the regulations (sec. 1.6041-2(a)(1)) specify that earnings in addition to those required to be reported as subject to withholding are required to be reported separately to the IRS on the Form W-2 for the employee.

In Revenue Ruling 76–231, the IRS recently held that charge account tips not reported to the employer by the employee must nevertheless be reported to the IRS by the employer. If, because of tip-splitting or tip pooling, the amount reported by the employee on his income tax return differs from the total amount of tips reported by the employer for that employee, the employee is required by the ruling to attach an explanation of the difference to his income tax return.

Reasons for change

The requirement that employers report to the IRS charge account tips not reported to them by their employees appears to entail burdensome record-keeping requirements for many employers. As a matter of general practice, charge account tickets are turned over by, for example, a waiter to the business manager, who then, or shortly thereafter, reimburses the waiter from the cash register or other ready cash for the amount shown on the charge ticket which represents the waiter's tip. However, at the end of an accounting period, employers may have only a record of total charge account tips, and such employers would not necessarily have any way of breaking down that total per employee. In order to determine the amount of charge account tips received by each employee, such employers must go back to allocate each charge ticket to the employee responsible for it, if that employee's identity is identifiable from the charge ticket.

Congress is concerned that the new reporting rules contained in Revenue Ruling 76–231 (and in its predecessor, Revenue Ruling 75–400) may present a new and unnecessarily burdensome record-keeping requirement for some employers. Congress is also concerned, however, that the income of some highly compensated employees, such as maitres d'hotel, headwaiters, and waiters in expensive restaurants, may be seriously underreported to the IRS if they neglect to report the full amount of their charge account tips.

Explanation of provision

This section provides that the IRS is not to follow Revenue Rulings 75–400 and 76–231 until 1979, and that, in the meantime, the IRS requirements with regard to reporting charge account tips are to be made in accordance with IRS practice prior to the issuance of those rulings. Congress contemplates that, prior to 1979, the IRS and the affected employers will explore the possibility of finding methods of providing the IRS with the information it needs to avoid understatements of tip income while at the same time avoiding unduly burdensome record-keeping requirements for employers.

The passage of this section of the Act is not intended to affect the Service's present power to audit individuals with respect to tip income.

Effective date

This section is effective January 1, 1976. Under its revenue rulings, the IRS did not attempt to apply its new reporting requirements for employers for calendar years prior to 1976. As a result, the effective date of this section eliminates the need to comply with the revenue rulings, and it forgives any failure to have acted in accordance with the rulings.

Revenue effect

This provision is expected to result in a revenue loss of less than $5 million annually through 1978.

12. Treatment of Certain Pollution Control Facilities (sec. 2112 of the Act and secs. 48 and 169 of the Code)

Prior law

Five-year amortization initially was made available to a taxpayer at his election for pollution control equipment that was placed in service after 1968 in a plant or other property that was in existence before 1969. The election was available for equipment placed in service before January 1, 1976, at which time the provision expired. The provision was enacted as a special incentive for the installation of pollution control equipment in the Tax Reform Act of 1969, because that Act repealed the investment tax credit.

Rapid amortization was available for the installation of certified pollution control equipment with a useful life of up to 15 years. For equipment with a useful life greater than 15 years, the basis attributable to the first 15 years could be amortized over a 5-year period, and the remaining years could be depreciated under the regular rules for depreciation, including use of one of the several alternative methods of accelerated depreciation. Property that was eligible for rapid amortization was not made eligible for the investment tax credit when it was re-enacted in 1971.

In order to be eligible for rapid amortization, the pollution control equipment had to be certified as a new, identifiable treatment facility to be used in an existing plant to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes or heat. Certification was required by appropriate State and Federal authorities that the equipment complied with the appropriate standards.

In addition to the rapid amortization provision that had been in effect through 1975, taxpayers who placed pollution control equipment in service might be able to finance the cost of acquisition, in whole or in part, through the issue of industrial development bonds. Several conditions and limitations apply to the issue of these bonds in section 103 of the Code, and all taxpayers may not be able to qualify to issue these tax-exempt bonds. Under the Revenue Act of 1971, taxpayers who did not elect rapid amortization were able to use accelerated depreciation on ADR guideline lives and the investment credit. In many cases, this combination gave greater tax benefits than five-year amortization.

Reasons for change

Five-year amortization for certified pollution control equipment expired at the end of 1975 when a bill providing for a one-year extension was not enacted before adjournment.

Congress believes, however, that reenactment of this tax incentive is necessary to encourage the installation of pollution control equipment. The equipment is placed in service because public policy now requires that the cost of dealing with pollution be included in the prices of products as a cost of production. This transfers the cost burden of removing pollution created by the production process to the consumers of the product from the victims of pollution. The producers must install equipment that frequently is expensive and may not increase productivity. In recognition of this addition to a businessman's capital costs because of public policy, Congress believes that continuing this assistance in reducing the cost burden is appropriate.

After restoration of the investment credit in 1971, the amortization provision was used infrequently because the investment credit plus accelerated depreciation over ADR guideline lives provided greater tax benefits. Congress believes that the investment credit also should be made available in combination with rapid amortization to restore the viability of the amortization provision as an incentive.

Since enactment of the 1969 legislation, pollution control has been considered to be a process that takes place at the end of the production line. Congress believes that perspective has been excessively narrow and that a broader definition of pollution control is appropriate.

Explanation of the provision

The Act restores the five-year amortization provision as of January 1, 1976, as a permanent provision. The provision applies to a new, identifiable, certified pollution control facility installed in a plant in operation before January 1, 1976. The Act amends the prior law definition to cover pollution control equipment that prevents the creation of pollutants, as well their emission, which formerly had been the limit of the provision. In addition, the Act provides that a facility or equipment for which the taxpayer elects five-year amortization will be eligible for a one-half investment tax credit. The limited investment credit will not be allowed, however, where the useful life of the facility or equipment would be less than 5 years, as the useful life would be determined without regard to this amortization provision.

Under the Act, the election of five-year amortization applies to facilities that will prevent the creation or emission of pollutants when installed at the site of a plant or other property in existence before January 1, 1976, which do not lead to a significant increase in output or capacity, a significant extension of useful life, or a significant reduction in total operating costs for such plant or other property (or any unit thereof), or a significant alteration in the nature of a manufacturing production process or facility. For purposes of this provision, significant means a change of more than 5 percent. In determining how significant is the effect of a pollution control facility upon output, capacity, costs or useful life of property, the relevant area for examination is to be the operating unit most directly associated with the pollution control facility.

The expanded definition of pollution control facility includes, for example, a facility located at a plant site, which prevents the creation of a pollutant by removing sulphur from fuel before it is burned at the plant. The definition also includes a facility, such as a recovery boiler, that removes pollutants from material at some point in the otherwise unchanged production process at the plant. The Act does not include as a qualified pollution control facility a facility that functions as a new, or makes a significant change in a, manufacturing or production process or facility. For example, where a plant that has employed heat to process a material changes to an electrolytic process, the latter is not a qualified pollution control facility because it is also a new manufacturing or production process even though it may prevent the creation and emission of pollutants.

Congress also made clear, in its approval of the conference agreement, that the broader definition of a pollution control facility which is eligible for the amortization election does not apply in determining whether a facility is a pollution control facility eligible for tax-exempt industrial development bond financing.

The Act also makes available an investment credit equal to one-half of a full credit for qualified pollution control facilities having a useful life of 5 years or more.

Effective date

Restoration of the election for five-year amortization is effective with respect to certified pollution control equipment which is placed in service after December 31, 1975. The investment credit will generally be available for such equipment placed in service after December 31, 1976.

Revenue effect

This provision will increase tax receipts by $59 million in fiscal year 1977 and by $102 million in fiscal year 1978. There will be a decrease in tax receipts of $160 million in fiscal year 1981.

13. Clarification of Status of Certain Fishermen's Organizations (Sec. 2113 of the Act and sec. 501 of the Code)

Prior law

Agricultural organizations are exempt from Federal income tax under section 501(c)(5) of the Code. Organizations devoted to promoting or improving fishing or such related occupations as taking shrimp or lobsters, however, were not treated as agricultural organizations by the Internal Revenue Service.[1] Organizations devoted to promoting or improving fishing and related pursuits could qualify, on the other hand, for tax exemption under section 501(c)(6) as business leagues.[2]

Pursuant to statute and implementing regulations of the U.S. Postal Service,[3] agricultural organizations qualify as tax-exempt organizations and accordingly enjoy special lower second- and third-class mail rates. The U.S. Postal Service has followed the Internal Revenue Code in refusing to classify fishing organizations as agricultural organizations, and, as a result, fishing organizations did not enjoy the lower postal rates given to organizations classified as agricultural organizations.

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[1] The provisions of prior law defining agricultural pursuits or farming did not encompass fishing and similar pursuits. (See secs. 3121(g) and 6420(c).)

[2] Payments to section 501(c)(5) organizations or to section 501(c)(6) organizations are not deductible as charitable contributions. However, in most cases payments to these organizations are deductible as business expenses.

[3] 39 U.S.C. § 4452(d) as reaffirmed by the Postal Reorganization Act of 1970 and pursuant to the Domestic Mail Classification Schedule adopted by the Board of Governors of the U.S. Postal Service under the authority of the Postal Reorganization Act.

Reasons for change

Congress believes that there is no valid reason for differentiating under section 501(c)(5) between occupations devoted to producing foodstuffs from the earth and occupations devoted to producing foodstuffs from water. In addition to the specific practical consequence of influencing the U.S. Postal Service to refuse to give organizations or leagues devoted to fishing and related pursuits the reduced postal rates granted to agricultural organizations, this distinction may have had further practical and undesirable consequences in the future had it not been eliminated.

Explanation of provision

This section adds a new provision (new subsection (g) of section 501 of the Code) to explain the meaning of the word "agricultural" in section 501(c)(5). The amendment provides that "agricultural" includes "the art or science of cultivating land, harvesting crops or aquatic resources, or raising livestock."

The term "harvesting * * * aquatic resources" includes fishing and related pursuits (such as the taking of lobsters and shrimps). Both fresh water and salt water occupations are to qualify as "agricultural" under the new definition. In addition, the cultivation of underwater vegetation, such as edible sea plants, qualifies as agricultural in nature,[4] as does the cultivation or growth of any edible organism. Also, the operation of "fish farms" is to be considered agriculture under the new definition. However, aquatic resources are only to include animal or vegetable life, not mineral resources.

Congress does not intend the definition of "agricultural" to be all encompassing. The term is not necessarily to be limited to "the art or science of cultivating land, harvesting crops or acquatic resources, or raising livestock."

Effective date

This provision applies to taxable years ending after December 31, 1975.

Revenue effect

This provision is expected to result in a revenue loss of less than $5 million annually.

14. Innocent Spouse (sec. 2114 of the Act and sec. 6013(e) of the Code)

Prior Law

Ordinarily under section 6013(e), an innocent spouse may be relieved of the generally applicable rule of joint and several liability on a joint return if the liability is attributable to omissions of income for which the spouse seeking relief is not responsible.

Under prior law, relief could have been sought for all taxable years which were still open when that provision was enacted (January 12,

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[4] No inferences are to be drawn from this provision as to whether any pursuit that may qualify under the new term did or did not qualify under prior law.

1971), but could not be granted for a year which was already closed by the statute of limitations, res judicata, or otherwise.

If certain conditions are met, relief may be granted to an innocent spouse who filed a joint return which omitted income in excess of 25 percent of the income actually reported. The spouse seeking relief must establish that he or she did not know of and had no reason to know of the omission. Also, it must be concluded that it is inequitable to hold the innocent spouse liable for the tax deficiency. A determination about whether it is inequitable to hold an innocent spouse liable must be based on all the facts and circumstances and must consider whether the innocent spouse benefitted significantly from the omitted income.

Relief under this provision covers liability for tax, interest, penalties and other amounts. Although Congress was especially concerned with granting relief to innocent spouses of embezzlers who fail to report income fully, the relief may cover any type of omission.

Reasons for change

The Congress believed that relief should be granted in certain cases where an innocent spouse was unable to obtain relief under prior law solely because a judicial decision had rendered an issue res judicata. The Congress believed it appropriate to alleviate the undue hardship imposed on an innocent spouse (1) who became liable for tax because of the res judicata effect of a judicial decision prior to the enactment of this provision and (2) who could have benefitted from the provision if he or she had kept the taxable year in question open within the tax administrative process and had not sought judicial relief.

Explanation of provision

The Act grants relief under the innocent spouse provision to certain taxpayers, who but for the res judicata effect of adverse judicial decisions prior to the provision's enactment, would have been relieved of liability for unreported income.

Except for the application of the section to certain closed years, the substance of the provision under prior law and as amended by this Act is the same.

Under the Act, a taxpayer may apply under section 6013(e) for redetermination of his or her tax liability for taxable years beginning within ten years prior to the enactment of section 6013(e) and ending on or before January 12, 1971, the date of enactment of that provision, if such relief has been barred solely by operation of res judicata. A redetermination sought under the Act is to be made without regard to the res judicata effect of a judicial decision. Taxpayers found to have overpaid their taxes are to be entitled to refunds.

Effective date

The application permitted by the Act must be made before the end of the first calendar year beginning after the date of enactment of this Act.

Revenue effect

It is estimated that this provision involves a negligible revenue loss.

15. Rules Relating to Limitations on Percentage Depletion in Case of Oil and Gas Wells (sec. 2115 of the Act and sec. 613A of the Code)

Prior law

Prior to the Tax Reduction Act of 1975 any taxpayer was entitled to a deduction for the greater of the percentage depletion allowance or the cost depletion allowance on gross income from an oil and gas property. The percentage allowance was equal to 22 percent of such gross income, but not more than 50 percent of the taxable income from such property.

The Tax Reduction Act of 1975 repealed the percentage depletion allowance for oil and gas with two exceptions. Under the first exception, natural gas sold under a fixed contract or subject to federal price regulation is still eligible for percentage depletion computed without regard to the limitations on percentage depletion contained in the Tax Reduction Act of 1975. Under the other exception (the "small producer exemption"), percentage depletion is allowed for a limited amount of production from wells located within the United States. The amount of production eligible for percentage depletion is an average of 2000 barrels per day (or its equivalent in cubic feet of gas) for 1975 and phases down to an average of 1000 barrels per day (or its equivalent in cubic feet of gas) for 1980 and thereafter. The percentage depletion rate for eligible production remains at 22 percent through 1980 and then is gradually reduced annually to 15 percent for 1984 and years thereafter. However, production resulting from secondary and tertiary recovery processes remains eligible for the 22 percent rate through 1983.

For any taxpayer eligible for the small producer exemption, the deduction for any year attributable to such small producer exemption may not exceed 65 percent of the taxpayer's taxable income. If a taxpayer acquired an interest in an oil and gas property after 1974 and the property is "proven" at the time of transfer, the taxpayer is generally not allowed percentage depletion on production from that property under the small producer exemption. Also, a taxpayer is not eligible for the small producer exemption on any oil or gas production during any period for which such taxpayer is classified as a "retailer" of oil or gas, or products derived from oil or gas. Finally, a taxpayer is ineligible for the small producer exemption for any taxable year for which the taxpayer (or a related person) engages in refining of crude oil if, on any day during the year, he has refinery runs exceeding 50,000 barrels.

Generally, a taxpayer is subject to the "retailer" exclusion for any taxable year in which the taxpayer either directly, or through a related person, sells oil or gas (or any product derived from oil or gas) either (a) through a retail outlet operated by the taxpayer or a related person, or (b) to any person who is obligated under a contract with the taxpayer (or a related person) to use the trademark, etc. of the taxpayer (or a related person) in marketing oil and gas (or derivative products), or who is given authority under a contract to occupy a retail outlet controlled by the taxpayer.

Reasons for change

Certain provisions of the Tax Reduction Act of 1975 relating to percentage depletion have been or might have been interpreted in a manner which is inconsistent with what the Congress believes to have been its intent in enacting that legislation. In some cases, the literal language of the statute requires unintended results. In other cases, the statutory language is ambiguous.

First, the retailer exclusion could have been construed to apply in many cases where it was not intended to apply. For example, the retailer exclusion could have been interpreted to deny the small producer exemption to a royalty interest holder who also holds a mere 5-percent interest in a partnership that operates a corner drugstore which sells petroleum jelly. The Congress believes that the retailer exclusion should apply only where the taxpayer has substantial retail operations and not to cases where a taxpayer's retail operations are essentially *de minimis*. In addition, the Congress believes that the retailer exclusion should be applied only in the case of retail sales as that term is commonly used. Thus, bulk sales of oil or natural gas directly to industrial or commercial users should not be treated as retail sales through a retail outlet. Nor should retail sales be taken into account if they take place outside the United States, provided the taxpayer is not exporting oil, gas, or derivative products.

The rule prohibiting the percentage depletion deduction on proven property which has been transferred was intended to prevent a proliferation of the amount of proven oil and gas reserves that might be eligible for percentage depletion when produced. The Congress believes that the rule was not intended to apply to some cases of transfers which occur by operation of law. For example, where a property is held in trust and the beneficiaries are entitled to percentage depletion with respect to the property, the birth or death of a beneficiary may constitute a transfer. This kind of a transfer was not intended to give rise to the denial of percentage depletion. Also, the Congress believes that transfers within a commonly controlled group should not result in the loss of percentage depletion, so long as the transferor and transferee both remain part of the commonly controlled group subject to a single limitation on their depletable oil.

Finally, it came to the attention of the Congress that the Treasury Department has encountered administrative difficulties as a result of certain technical problems in the new depletion rules. To correct any possible defects, the Congress adopted certain technical amendments for clarification.

Explanation of provisions

The Act makes several changes in the retailer exclusion. First, bulk sales of oil or natural gas directly to industrial or commercial users are treated as not constituting retail sales. Second, where gross receipts from the sale of oil or gas, or products derived therefrom, by all retail outlets of the taxpayer (or related persons) do not exceed $5 million for the taxable year, that taxpayer will not be treated as a retailer for that year. Thus, if the taxpayer and related persons operate a total of five outlets, the taxpayer will be subject to the retailer exclusion only if the aggregate gross receipts from the sale of oil, gas, or their derivative products by these outlets exceed $5 million for the year. This *de minimis* exception applies to retail outlets occupying land owned, leased or controlled by the taxpayer as well as those outlets owned directly by him.[1] Also, a taxpayer will not be subject to the retailer exclusion for any taxable year for which all retail sales of oil, gas, or their derivative products by retail outlets are made outside the United States, provided that no domestic production of the taxpayer or a related person is exported during the year in question or the immediately preceding taxable year.

The Act also adds an additional exception to the transfer rule. Under this exception, no change of beneficiaries of a trust shall be considered a "transfer" if the change occurs solely by reason of the death, birth, or adoption of any beneficiary if the transferee was a beneficiary under the trust prior to the triggering event or is a lineal descendant of the grantor or any other beneficiary.[2]

Under the trust laws of certain States, as well as the provisions of some existing trust instruments, part or all of the depletion allowance is required to be allocated to the trustee, even though income distributions are made to beneficiaries. Such distributions reduce the taxable income of the trust and, because of the 65 percent limitation, jeopardize the deduction under the small producer exemption. The Congress believes that this result was not intended. Thus, to correct this situation, the Act provides, for purposes of the 65-percent-of-taxable-income limitation, that a trust's taxable income shall be computed without a deduction for distributions to beneficiaries during the taxable year. In addition, the language of prior law was changed to make clear that in computing taxable income for purposes of the 65-percent-of-taxable-income limitation, percentage depletion under the small producer exemption is not treated as a deduction from taxable income. (Otherwise, there would be a circle, with percentage depletion reducing the base of taxable income against which the 65-percent limitation is measured.) However, if a property is exempted from the provisions of these limitations on percentage depletion (because it produces a regulated natural gas, etc.), then taxable income would be reduced by the depletion taken. Also, if the cost depletion deduction allowable on one or more of the taxpayer's oil or gas properties is greater than the percentage depletion deduction allowed under this section (without regard to the limitation based on taxable income) then the entire amount of allowable cost depletion must be deducted in computing taxable income for purposes of the 65-percent limitation.

Under the tax law, percentage depletion is to be computed by each partner in the case of an oil or gas property held by a partnership. Some partners may be limited to cost depletion by reason of the various limitations and exclusions, while other partners will be entitled to percentage depletion. Whatever depletion allowance is deducted by the partners reduces the basis of the partnership property. The basis affects the amount of the cost depletion allowance for any year, as well as the amount of gain or loss recognized upon a sale or exchange of such property.

In the case of partnerships having numerous partners, difficulty arises if the partnership is required to maintain the basis account for

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[1] For purposes of the retailer exclusion, bulk sales by the producer of oil or natural gas directly to commercial or industrial users are not to be taken into account. Therefore, this type of sale is also not to be taken into account for purposes of the *de minimis* rule.

[2] For this purpose, an individual adopted by a beneficiary is a lineal descendant of that beneficiary.

partnership oil or gas property. The partnership would have to ask that each partner inform the partnership annually of the amount of depletion deducted with respect to each property. This practice would be burdensome and unreliable. Moreover, if the basis of the property were maintained at the partnership level, deductions by partners entitled to percentage depletion would reduce the basis and jeopardize the cost depletion allowance for those partners not entitled to percentage depletion. Also, on a subsequent sale of the property, partners limited to cost depletion would recognize the same portion of gain or loss as those partners entitled to percentage depletion. These results were not intended under the Tax Reduction Act of 1975 which provided that percentage depletion under the small producer exemption is to be complied at the partner level. Accordingly, the Act clarifies existing rules so that the partnership basis in oil or gas properties is allocated to partners proportionately. Thereafter, each partner maintains an individual basis account and computes his own allowance for either percentage depletion or cost depletion on all his oil and gas properties.[3]

As noted above, under the tax law a retailer (or a refiner) is not eligible for the small producer exemption if he directly, or through a related person, sells oil, natural gas, or products derived therefrom through a retail outlet (or annually refines a certain amount of crude oil). The definition of a related person is based on a significant ownership test. However, the definition under prior law did not specify that a significant ownership interest is held when a person indirectly holds a significant ownership interest in another person. In order to prevent taxpayers from avoiding the retailer and refiner exclusions by the use of intermediate entities, the Act clarifies the law by specifically providing that in determining whether a significant ownership interest is held, an interest owned by or for a corporation, partnership, trust, or estate shall be treated as owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries, as the case may be.

The Act also permits percentage depletion to be retained on property which is transferred by individuals, corporations and other entities, all of which are part of the same controlled group after the transfer (and thus must continue to combine oil production to determine the maximum number of barrels of oil eligible for percentage depletion). However, if any transferee ceases to be part of the same controlled group as the transferor at some later time, percentage depletion is to be disallowed with respect to the transferred property as of that date (in order to prevent a proliferation of the limited exemption from the repeal of percentage depletion).

For example, under the Act, the wife and minor children of a producer could receive part ownership in a proven property without loss of depletion because they are all treated as one taxpayer for percentage depletion purposes. Other examples would include transfers between business entities under common control, within the same controlled group of corporations, and to a trust to the extent the beneficiaries of the trust are members of the family of the grantor of the trust.

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[3] For this purpose, the partner adjusts his basis for his individual deductions for depletion and he separately computes gain or loss on the proceeds from the sale or exchange of an oil or gas property.

Effective date

These provisions are effective on January 1, 1975, for taxable years ending after December 31, 1974 (the effective date of the provisions relating to the percentage depletion deduction in the Tax Reduction Act of 1975).

Revenue effect

This provision will reduce budget receipts by $24 million in fiscal year 1977, $10 million in fiscal year 1978, and $10 million in fiscal year 1981.

16. Federal Collection of State Individual Income Taxes (sec. 2116 of the Act and secs. 6361 and 6362 of the Code)

Prior law

A State may elect to have the Internal Revenue Service collect the State's individual income tax if the State enters into an agreement with the Internal Revenue Service, and if the State individual income tax is a qualified tax. However, under prior law the piggyback system was "triggered" only when two States, representing at least 5 percent of Federal individual tax returns, enter into an agreement with the Treasury to have their taxes collected by the Treasury.

Three types of State taxes are qualified: taxes on residents' income based on Federal taxable income at rates determined by the States; taxes on residents' income which are a percentage of the Federal liability; and taxes on nonresidents' wage and other business income.

Generally, for a tax based on taxable income to qualify for Federal collection, the State tax must be imposed on an amount equal to an individual's taxable income for the taxable year, as such income is defined from time to time in the Internal Revenue Code of 1954. Three adjustments must be made to the tax base in order for the tax to qualify for Federal collection: (1) subtract from Federal taxable income any interest received on U.S. obligations received by a taxpayer and included in Federal gross income, (2) add to Federal taxable income any deductions claimed by a taxpayer for net State and local taxes, and (3) add to Federal taxable income the interest from obligations of States or political subdivisions which is exempt from Federal income tax. Also a State may impose a "minimum tax" on tax preferences and allow a credit for income taxes paid to another State or a political subdivision of another State.

A qualified resident tax computed as a percentage of Federal tax is defined as one imposed on the excess of the taxes imposed by chapter 1 of the Internal Revenue Code over the sum of the nonrefundable credits allowable against these taxes. This includes in the base the Federal liability for the minimum tax. As with the tax based on Federal taxable income, certain adjustments are provided by the Act for the tax based on a percentage of the Federal tax, as follows: (1) decrease liability on account of interest on U.S. obligations included in Federal taxable income, (2) increase liability by including net tax-exempt income, (3) increase liability by adding back net State income tax deduction, and (4) allow a credit for income tax paid to another State (or political subdivision).

Finally, a nonresident tax will not be qualified unless the amount of tax imposed by a State on the income of a nonresident does not exceed the tax that would be imposed by the State if he were a resident and if his taxable income were an amount equal to the excess of his wage and other business income derived from sources within the State, over that portion of the nonbusiness deductions allowable under the State's qualified resident tax which bears the same ratio to the total of such deductions that the wage and other business income derived from sources within the State bears to the taxpayer's adjusted gross income.

Reasons for change

To date, the requisite two States with 5 percent or more of 1972 Federal individual income tax returns have not "triggered" the piggyback system. This reluctance on the part of the States stems from apparent uncertainty about whether or not the Federal Government would bear the costs of administering the collection of State taxes, even though the 1972 legislation contemplated that the Federal Government and not the States, would bear those costs. Also, there was concern that certain progressive features of current State individual income taxes would be eliminated were a State to elect to piggyback, and there may have been coordination problems among several States to jointly elect and therefore trigger the piggyback system.

To remove those impediments, the Act (1) makes it clear that the Federal government will bear the costs of piggybacking, (2) permits States to provide sales tax credits, and (3) eliminates the 5-percent-of-returns rule and lowers the trigger to one State.

Explanation of provision

The Act makes explicit Congress' intent that the Federal Government will not charge any State, directly or indirectly, for Federal administration of the State's income taxes under the piggybacking provisions.

The Act also reduces to one State the number of States needed to set off this trigger, and removes the requirement of prior law that the initially-electing State or States must represent, in the aggregate, 5 percent or more of the Federal individual income tax returns filed during 1972.[1] This has the effect of permitting a State to make its decision whether to elect piggybacking based on its own needs, without having to predict whether that State will be joined by other States of any given size.

Finally, the Act permits a State to provide a credit for State sales tax against State income tax. Such credits are increasingly being made available under existing State laws and are generally designed to reduce the regressive effects of flat-rate State sales taxes, especially when such taxes are imposed on food.

Effective date

This provision is to take effect on the date of enactment (October 4, 1976).

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[1] While the trigger is reduced to one State, piggybacking becomes effective within the notification process of prior law, i.e., the first January 1 which is more than one year after the date of notification.

Revenues effect

This provision is not expected to have any effect on Federal revenues.

17. Cancellation of Certain Student Loans (sec. 2117 of the Act and sec. 117 of the Code)

Prior law

Gross income means all income, from whatever source derived, including income from discharge of indebtedness, unless otherwise provided by law (sec. 61). However, subject to certain limitations, gross income does not include any amount received as a scholarship at an educational institution or as a fellowship grant (sec. 117(a)). An amount paid to an individual to enable him to pursue studies or research does not qualify as a scholarship or fellowship grant if such amount represents compensation for past, present or future employment services or if such studies or research are primarily for the benefit of the grantor (Regs. § 1.117–4(c)).

Under certain student loan programs established by the United States and various State and local governments, all or a portion of the loan indebtedness may be discharged if the student performs certain services for a period of time in a certain geographical area pursuant to conditions in the loan agreement. In 1973, the Internal Revenue Service ruled on a situation in which a State medical education loan scholarship program provided that portions of the loan indebtedness are discharged on the condition that the recipient practices medicine in a rural area of the State. The condition that services be performed in an area selected by the grantor imposes a substantial *quid pro quo*, so that the services are primarily for the benefit of the grantor. Therefore, the Service determined that amounts received from such a loan program were included in the gross income of the recipient to the extent that repayment of a portion of the loan is no longer required (Rev. Rul. 73–256, 1973–1 C.B. 56). On November 4, 1974, the Service determined that this ruling would be applied only to loans made after June 11, 1973, the date of the above ruling (Rev. Rul. 74–540, 1974–2 C.B. 38).

Reasons for change

Many States and cities have experienced difficulty in attracting doctors, nurses and teachers to serve certain areas, including both rural communities and low-income urban areas. A provision in student loan programs for loan cancellation in certain circumstances is intended to encourage the recipients, upon graduation, to perform needed services in such areas. Proponents of these programs believe that the loan cancellation is not primarily for the benefit of grantor, as the Service has ruled, but for the benefit of the entire community and that the exclusion from income of the amount of indebtedness discharged in exchange for these services would further the purpose of the programs. In addition, proponents believe the exclusion would be consistent with the treatment of scholarships and fellowship grants which are not contingent upon the performance of needed services by the recipient.

Explanation of provision

The Act provides that no amount shall be included in gross income by reason of the discharge of all or part of the indebtedness of the individual under certain student loan programs if the discharge was pursuant to a provision of the loan agreement under which all or part of the indebtedness of the individual would be discharged if the individual works for a certain period of time in certain professions in certain geographical areas or for certain classes of employers. This provision applies to student loans made to an individual to assist him in attending an educational institution only if the loan was made by the United States or an instrumentality or agency thereof or by a State or local government, either directly or pursuant to an agreement with an educational institution.

The House Ways and Means Committee has indicated that it plans, with the assistance of the Internal Revenue Service, to study the treatment of scholarships and fellowships, including student loans that are forgiven.[1] To allow further study in this area, the provisions of this section are effective through December 31, 1978.

Effective date

The amendment made by this section shall apply with respect to loans forgiven prior to January 1, 1979.

Revenue effect

It is estimated that this provision will have only a negligible revenue loss.

18. Simultaneous Liquidation of Parent and Subsidiary Corporations (sec. 2118 of the Act and sec. 337 of the Code)

Prior law

A corporation which adopts a plan of complete liquidation and, within 12 months thereafter, sells or exchanges some or all of its assets and liquidates completely generally does not recognize gain or loss from the sale or exchange (sec. 337). Its shareholders will ordinarily be taxable, however, on the sale proceeds which they receive as part of the liquidating distributions made to them (sec. 331).

Under prior law this corporate nonrecognition rule did not apply, however, if the corporation making the sale or exchange was an 80 percent or greater controlled subsidiary of a parent corporation and if the parent took a carryover basis in the assets of the subsidiary when it liquidated the subsidiary (former sec. 337(c)(2)).

Reasons for change

The purpose of the general rule freeing the corporation from tax on a gain from a sale of its assets followed by a complete liquidation is to eliminate the need for determining whether a corporation in the process of completely liquidating, which distributes some of its assets to its own shareholders who then complete a sale of the asset to a third party, should be treated for tax purposes as remaining taxable on the sale or whether the shareholders receiving the assets should be treated as taxable on the sale.

However, if a corporate shareholder of a company which sells its assets is not taxable when it liquidates the subsidiary (as occurs under sec. 332), and if the subsidiary were not taxable on a gain from selling

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[1] Report of the Committee on Ways and Means (H. Rept. 94-658; November 12, 1975), p. 427.

its assets, no tax at all would be paid on the gain represented by the sale proceeds. Hence, prior law (sec. 337(c)(2)) required that a controlled subsidiary must recognize gain or loss where it sells its assets and then liquidates into its parent.

In some situations, however, where both the parent and the subsidiary plan to liquidate after a sale of property by the subsidiary (and sometimes after the parent also sells some or all of its assets at the same time), it is less important to tax the subsidiary on its gain from a sale of assets. In fact, two taxes were often required by prior law in this situation: a sale of assets by the subsidiary was subject to tax (in light of former section 337(c)(2)), and the shareholders of the parent corporation also recognized gain when the parent liquidated (sec. 331). The Internal Revenue Service had held, however, that this tax result could be avoided if the parent first liquidated the subsidiary into itself (without recognizing gain or loss by reason of sec. 332) after which the parent adopts its own plan of liquidation (under sec. 337) and then sells the assets formerly owned by the subsidiary. Under that sequence, neither the parent nor its subsidiary would recognize gain or loss and the parent's shareholders alone would recognize gain or loss on the liquidation of the parent.[1]

Alternatively, the parent could distribute its subsidiary's stock to the parent's own shareholders who would be taxable on the value of the subsidiary at that time, but if the shareholders then caused the subsidiary to sell its assets under the rules of section 337, the exception in former section 337(c)(2) would be avoided, and no second tax would be required (because of basis adjustments at the shareholder level) on the asset sale or on liquidation of the subsidiary.[2]

Congress believes that, consistent with the underlying purpose of section 337, the sequence of formal steps taken by the parties in this type of situation should not determine what tax results occur.

Explanation of provision

The Act permits the general nonrecognition rule of section 337(a) to apply to a controlled subsidiary which sells property and then liquidates completely, provided that the parent corporation also liquidates completely in the same transaction. In order to obtain nonrecognition of gain or loss, all other generally applicable requirements of section 337 would have to be satisfied (such as the rule that the sale or exchange of property must occur within 12 months after the subsidiary adopts a plan of complete liquidation). In this situation, not only must the selling subsidiary make a liquidating distribution of all of its remaining assets (less assets retained to meet claims) within 12 months after its plan of liquidation is adopted, but, in addition, during the same 12-month period, the parent corporation must also distribute all of its assets in its own complete liquidation. (The parent will be regarded as having liquidated completely for purposes of this rule even though it retains assets to meet claims.)

Because sec. 337(a) will be applicable to the selling subsidiary in this situation, gain on a sale of the subsidiary's assets will not be rec-

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[1] See Rev. Rul. 69–172, 1969–1 Cum. Bull. 99.

[2] Under prior law, the Tax Court had held that the statutory intent behind former sec. 337(c)(2) was not to deny a selling subsidiary the benefit of section 337 where both the subsidiary and its parent simultaneously sold their assets to a third party and completely liquidated. *Kamis Engineering Company,* 60 T.C. 763 (1973).

organized by the subsidiary if the subsidiary makes the sale or if, under the so-called "Court Holding Company principle," a sale by the parent can be treated for tax purposes as having been made by the subsidiary.[3] A realized loss on a sale by the subsidiary of property which has declined in value will similarly not be recognized.

If the selling subsidiary is a member of a group of controlled subsidiaries having a common parent corporation, the new rule requires in effect that all other subsidiaries in the direct line of stock ownership above the level of the selling subsidiary must also liquidate completely. These other subsidiaries must distribute their assets (less assets retained to meet claims) in complete liquidation within the 12 month period beginning on the date of adoption of the selling subsidiary's plan of liquidation.[4] The effect of requiring the liquidation of all subsidiaries in a chain above the selling subsidiary is to eliminate a "Court Holding Company" problem which could otherwise continue to exist in this type of situation. For example, assume that a parent corporation, P, owns all the stock of subsidiary S–1, which in turn owns all the stock of subsidiary S–2, and that S–2 sells its assets after adopting a section 337 plan. The effect of not requiring S–1 to liquidate would be to leave a possible continuing fact question in some cases as to who should be treated for tax purposes as having made a sale of property. If S–2 were treated as the seller of its assets for tax purposes, section 337 would protect S–2 against recognition of gain or loss; however, if on the facts the Commissioner could successfully contend that S–1 negotiated the sale and therefore S–2 should be treated as having made a liquidating distribution of the property in kind of S–1, which then completed the sale, S–1 could be required to recognize gain or loss as if it had actually sold the assets. The Act eliminates the possibility of this kind of continuing factual difficulty by extending section 337 to an asset sale by S–2 on condition that both S–1 and P also liquidate completely. Then, even if S–1 could be treated as the seller for tax purposes, section 337 would apply at the level of S–1 to provide nonrecognition of its gain or loss.

Effective date

This provision is effective for sales or exchanges made pursuant to a plan of liquidation adopted on or after January 1, 1976.

Revenue effect

It is estimated that this provision will not have any significant effect on tax revenues.

19. Prepublication Expenses (sec. 2119 of the Act and secs. 61, 162, 174, 263 and 471 of the Code)

Prior law

The Internal Revenue Code (sec. 174(a)(1)) permits, under certain circumstances, an itemized deduction for research and experimental

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[3] See *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945) and *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950).

[4] For purposes of this rule, the group of corporations to which this rule applies must constitute an "affiliated group" as defined in section 1504(a). An affiliated group will qualify under this provision regardless whether the group elects (under sec. 1501) to file a consolidated tax return. Also for purposes of this rule, the exceptions to the definition of "includible corporation" contained in section 1504(b) are not to apply. Therefore, the members of the affiliated group are to be determined as if the corporations referred to in section 1504(b) were members of the group.

expenditures otherwise chargeable to a taxpayer's capital account. The regulations under this provision define research and experimental expenditures as expenditures incurred in connection with a taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The regulations specifically exclude expenditures for research in connection with literary, historical, or similar projects.

Prior to the enactment of this Act, the Internal Revenue Service held in Revenue Ruling 73–395 [1] that the costs incurred by an accrual basis taxpayer in the writing, editing, design and art work directly attributable to the development of textbooks and visual aids did not constitute research and experimental expenditures under section 174. The Service further held that these costs could not be inventoried (under sec. 471) but instead represented expenditures that must be capitalized (under sec. 263) and may be depreciated (under sec. 167(a)).

The ruling also stated that expenditures incurred in the actual printing and publishing of textbooks and visual aids should be inventoried (under sec. 471) with a part of the costs being apportioned to books and visual aids still on hand at the end of the taxable year. Also, expenditures for manuscripts and visual aids which were abandoned would be deductible as losses (under sec. 165).

Reasons for change

The Congress was made aware of the concerns of the publishing industry as to whether Revenue Ruling 73–395, as described above, correctly interpreted the law under section 174 as it applies to the publishing industry. The Congress understood that historically tax accounting practices in the publishing industry have varied greatly and no standard procedures have been developed. Industry members apparently have followed their own interpretations, particularly with regard to the treatment of publishers' prepublication expenditures. The Congress further was informed that in the case of these expenses, some publishers deducted them currently while other publishers capitalized them. The Congress believed that in view of the uncertainty with respect to the treatment of prepublication expenditures, the Internal Revenue Service should review this treatment and issue regulations to establish a uniform treatment of such expenditures for the entire publishing industry. This would allow interested taxpayers an opportunity to advise the Service about the practices and problems within the industry with respect to this matter. Since the Congress was concerned about the retroactive application of Revenue Ruling 73–395 which would affect practices consistently followed by many taxpayers for years, the Congress believed that any new rules applicable under regulations promulgated after the enactment of this Act should only have prospective application.

Explanation of provision

The provision generally allows publishers to continue their customary treatment of prepublication expenditures without regard to Revenue Ruling 73–395. The prepublication expenditures affected by

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[1] 1973–2 CB 87.

the provision are those paid or incurred in connection with the taxpayer's trade or business of publishing for the writing, editing, compiling, illustrating, designing or other development or improvement of a book, teaching aid, or similar product.

The provision allows taxpayers to treat their prepublication expenditures in the manner in which they have been treated consistently by the taxpayer in the past until new regulations are issued with regard to these expenditures after the date of enactment of this Act (October 4, 1976).

Any regulations issued by the Internal Revenue Service after the date of enactment of this Act are to apply prospectively only to taxable years beginning after their issuance. Until these regulations are issued, the Internal Revenue Service is to administer the application of sections 61 (as it relates to cost of goods sold), 162, 174, 263 and 471 to the prepublication expenditures of publishers without regard to Revenue Ruling 73–395. In addition, as indicated above, the Service is to administer these sections in the same manner as they were consistently applied by taxpayers prior to the issuance of Revenue Ruling 73–395. If a taxpayer did not consistently follow a specific tax accounting method, his returns will be treated by the Service in accord with usual administrative procedures.

Effective date

This provision is effective on the date of enactment of this Act.

Revenue effect

The provision will have little or no revenue effect because publishers would have benefitted by an IRS suspension of Revenue Ruling 73–395 [2] and would have neither reported nor paid the past tax liabilities assessed by the Service pursuant to its interpretation of the law as stated in that ruling. However, if the Service had not suspended audit and appellate activitiy in cases arising from its legal interpretation as evidenced in Revenue Ruling 73–395, and if no legislative bar on enforcement were enacted, publishers' past due tax liabilities could amount to several hundred million dollars.

20. Contributions to Capital of Regulated Public Utilities in Aid of Construction (sec. 2120 of the Act and secs. 118 and 362 of the Code)

Prior law

Generally, contributions to the capital of a corporation, whether or not contributed by a shareholder, are not includible in the gross income of the corporation (sec. 118). Nonshareholder contributions of property to the capital of a corporation take a zero basis in the hands of the corporation. If money is contributed by a nonshareholder, the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received or of certain other property is reduced by the amount of such contribution (sec. 362(c)).

Certain regulated public utilities (water and sewage disposal) have traditionally obtained a substantial portion of their capital needed for

[2] Press release IR–1575, March 17, 1976.

the construction of facilities through contributions in aid of construction. The concept of contributions in aid of construction originates from a line of early Board of Tax Appeals decisions dealing with amounts contributed by customers to public utilities to pay for extensions of service lines necessary to enable them to be serviced by the public utility. The decisions treated such amounts as not giving rise to taxable income to the public utilities.

In a 1958 ruling, the Internal Revenue Service announced that it would continue to follow the early case law with respect to contributions in aid of construction, but only with respect to *regulated* utilities. The ruling also indicated that any change of position would be given nonretroactive effect (Rev. Rul. 58–535, 1958–2 CB 25). In 1975, the Service issued Revenue Ruling 75–557 (1975–2 CB 33) which revoked the 1958 ruling, withdrew the IRS's acquiescence in the early line of cases, and held that amounts paid by the purchaser of a home in a new subdivision as a connection fee to obtain water service were includible in the utility's income. The ruling was made prospective for transactions entered into on or after February 1, 1976.

Reasons for change

The effect of the recent IRS ruling was to increase substantially the taxes of those utilities which had previously treated all contributions in aid of construction as nontaxable contributions to capital. These increased taxes would have ultimately resulted in higher charges to utility customers. Since such increased charges must be approved by public utility commissions, the working capital of the utilities could have been substantially reduced resulting in delays in furnishing service and curtailment of expansion of service. Further, the immediate inclusion of such contributions in income would cause a mismatching of income and related expense since the utility must increase income in the year in which the contributions are received, even though most of the expenses attributable to those facilities would not arise until subsequent years.

The Congress believed that the treatment of contributions in aid of construction by water and sewage disposal utilities should be continued by providing that contributions in aid of construction received by such utilities from an existing or potential customer, a builder or developer, a governmental body, or any other person will constitute a contribution to capital. However, the Congress also believed that nontaxable treatment should not be accorded to customer connection fees and to contributions to utilities which are not required to serve the general public.

Explanation of provisions

This provision amends the current rules concerning nonshareholder contributions to capital by specifying that amounts received as contributions in aid of construction by a water or sewage disposal utility (described in section 7701(a)(33)(A)(i)) which are used for qualified expenditures and which are not included in the rate base for rate making purposes by the regulatory body having rate-making jurisdiction are to be treated as nontaxable contributions to the capital of the utility.

For this purpose, the Secretary is to prescribe rules defining what items and amounts constitute a contribution in aid of construction. The following are examples of facilities which the Congress considers to be contributions in aid of construction.

(1) A builder or developer constructs water lines and/or support facilities such as water filtration plants, water towers, etc., and turns such facilities over to a regulated water or sewage disposal utility.

(2) A builder or developer furnishes the necessary funds to a regulated water or sewage disposal utility which uses those funds to build certain water or sewage disposal facilities.

(3) A builder or developer pays for the water or sewage disposal facility (commonly referred to as an "advance") in return for the qualifying utility agreeing to pay the developer a percentage of the receipts from the facilities over a fixed period. Where the total payments made to the developer are less than the cost of the facilities which are transferred to the utility, any difference is to be treated as a contribution in aid of construction.

(4) Governmental units furnish regulated water or sewage disposal utilities with relocation fee payments where the local jurisdiction requires that certain construction be done by the utility in order to achieve a desired purpose of the government unit, *e.g.*, tearing up an old road to be replaced by a new one may require replacement of certain underground pipies and lines, providing additional sewage disposal facilities as a result of drainage projects, etc.

Under the Act, nontaxable treatment is not accorded to customer connection fees. Customer connection fees include any payments made by a customer to the utility for the cost of installing the connection between the customer's property and the utility's main water or sewer lines (including the cost of meters and piping) and any amounts paid as service charges for stopping or starting service.

Where a utility receives a lump-sum amount as a payment for items which qualify for nontaxable treatment under this provision and for items which do not so qualify (such as customer connection fees), then the portion which qualifies for nontaxable treatment under this provision is to be determined on a case by case basis under the facts and circumstances of each case. In addition, the mere fact that the applicable rate-making authority classifies an amount received by a utility as an amount for which nontaxable treatment is permitted is not conclusive of nontaxable treatment if such amounts actually are for items for which nontaxable treatment is not permitted.

In addition, a requirement is added to insure that nontaxable treatment is accorded to only those utilities that are required to serve the public.

A qualified expenditure is an amount which is expended for the acquisition or construction of tangible property described in section 1231(b),[1] where the acquisition or construction of the facility was the purpose motivating the contribution (*i.e.*, the purpose for which such amounts were received). Such capital assets must be used predominantly (*i.e.*, 80% or more) in a trade or business of furnishing water or sewerage services to the utility's customers. Such expenditure must

[1] For this purpose, a capital asset includes all expenditures which must be capitalized for such facilities under the normal rules of tax accounting (sec. 263).

occur by the end of the second taxable year after the year in which the money was received.[2] For this purpose, the Congress intends that amounts received by the utility which are subject to being returned to the payer, if the cost of the facility is less than projected, are not subjected to these rules so long as the repayment occurs within the 2-year period during which qualified expenditures can be made. Any amounts not so expended must be included in income for the taxable year in which such amounts were received. In addition, accurate records must be kept of the amounts contributed on the basis of the project for which the contribution was made and by year of contribution.

No depreciation may be claimed and no investment credit may be taken with respect to any property acquired as a result of a qualified expenditure.[3] If a taxpayer wishes to change its present practice of treating contributions in aid of construction to a practice which is consistent with this provision, such change constitutes a change in method of accounting.

In providing these special rules for water and sewage disposal companies, the Congress intends that no inference should be drawn as to the proper treatment of such items by companies which are not water or sewage disposal utilities.

Effective date

This provision is to be effective for contributions made on or after February 1, 1976.

Revenue effect

This provision will reduce budget receipts by $16 million in fiscal year 1977, $11 million in fiscal year 1978, and $11 million in fiscal year 1981.

21. Prohibition of Discriminatory State Taxes On Production and Consumption of Electricity (sec. 2121 of the Act)

Prior law

Federal statutes provide few limitations on the power of States to tax nondomiciliaries or to impose special taxes on goods or services produced in the taxing State for nondomiciliary use outside the taxing State.

However, Public Law 86–272 [1] established certain minimum standards upon the power of a State to tax nondomiciliaries selling in the taxing State in interstate commerce. That Act did not affect the powers of States to tax goods or services produced within its boundaries for consumption outside its boundaries. Title II of the Act, however, also provided for further "studies of all matters pertaining to the taxation of interstate commerce. . . ."

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[2] The expenditure also can occur anytime before the contribution in aid of construction is received. For example, if the utility installed a water main for a customer in 1977, amounts received as contributions in aid of construction in years after 1977 from the customer are not taxable to the extent that the utility had made previous qualifying expenditures or makes qualifying expenditures within the 2-year period.

[3] However, in the case of an "advance" (described in item number 3, above), the payments made by the utility to the developer would be considered as a capital expenditure in the year of payment. In such a case, the payments should be allocated proportionately to the basis of each of the various assets acquired with the original contribution. Where such assets are depreciable, the allocated payments would be depreciable over the remaining useful life of that asset.

[1] 86th Cong., 1st Sess., 73 Stat. 555 (1959).

Reasons for change

Congress has learned that one State places a discriminatory tax upon the production of electricity within its boundaries for consumption outside its boundaries. While the rate of the tax itself is identical for electricity that is ultimately consumed outside the State and electricity which is consumed inside the State, discrimination results because the State allows the amount of the tax to be credited against its gross receipts tax if the electricity is consumed within its boundaries. This credit normally benefits only domiciliaries of the taxing State since no credit is allowed for electricity produced within the State and consumed outside the State.[2] As a result, the cost of the electricity to nondomiciliaries is normally increased by the cost the producer of the electricity must bear in paying the tax. However, the cost to domiciliaries of the taxing State does not include the amount of the tax.

Congress believes that this is an example of discriminatory State taxation which is properly within the ability of Congress to prohibit through its power to regulate interstate commerce.

Explanation of provision

This provision prohibits any State, or political subdivision of a State, from imposing a tax on or with respect to the generation or transmission of electricity if the tax discriminates against out-of-State manufacturers, producers, wholesalers, retailers, or consumers of that electricity. A tax is considered discriminatory if it directly or indirectly results in a greater tax burden on electricity which is generated and transmitted in interstate commerce than on electricity which is generated and transmitted in intrastate commerce.

This provision is not intended to prohibit, restrain, or burden any other State which currently imposes a nondiscriminatory tax on the generation of electricity.

This provision replaces the current Title II of Public Law 86–272, which is the title calling for further congressional studies. A number of studies of the problem of multistate taxation of interstate commerce have already been made by congressional committees, and the present Title II is not needed to authorize any additional studies that may be needed.

Effective date

The prohibition of discriminatory taxes made by this amendment is effective beginning June 30, 1974.

Revenue effect

This provision will have no impact upon Federal revenues.

22. Deduction for Cost of Removing Architectural and Transportation Barriers for Handicapped and Elderly Persons (sec. 2122 of the Act and sec. 190 of the Code)

Prior law

Under prior law, there were no special provisions for the tax treatment of expenditures to remove architectural and transportational barriers to the handicapped and elderly.

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[2] However, a credit for the amount of a tax on the production of electricity imposed by a second State is allowed against the first State's gross receipts tax if the electricity is consumed in the first State.

However, generally costs incurred for the improvement of property used in a trade or business must be capitalized. Such improvements may be depreciated over their useful life, if the period is determinable.

Reasons for change

In spite of previous Federal legislation to contend with the problem of architectural and transportation barriers to the handicapped and elderly, such barriers remain widespread in business and industry. The Congress believes that creating a tax incentive for a limited period could promote more rapid modification of business facilities and vehicles. In addition, the removal of barriers to the handicapped and elderly would increase their involvement in economic, social and cultural activities.

Explanation of provision

The Act provides electing taxpayers with a tax incentive for the removal of architectural and transportation barriers to the handicapped and elderly. An electing taxpayer may treat certain expenses for the removal of architectural and transportation barriers as deductible expenses in the year paid or incurred instead of capitalizing them. Deductible expenses are those paid or incurred in order to make more accessible to and usable by the handicapped and elderly any facility or public transportation vehicle owned or leased by the taxpayer for use in his trade or business. The maximum deduction for a taxpayer, including a controlled group of corporations filing a consolidated return, for a return for any taxable year is $25,000.

In order to qualify for the deduction, the expenses must be for barrier removal in business facilities which the taxpayer establishes to the satisfaction of the Secretary meet standards set by the Secretary of the Treasury with the concurrence of the Architectural and Transportation Barriers Compliance Board and as established by 1968 legislation.[1]

The definition of an elderly person under this provision is age 65 or over. Handicapped individuals include, but are not limited to, the blind and deaf.

The deduction is limited to a 3-year period in order that the Congress may review its cost effectiveness.

Effective date

This provision applies to taxable years beginning after December 31, 1976, and before January 1, 1980.

Revenue effect

This provision will result in a revenue loss of $4 million in fiscal 1977 and $10 million in fiscal 1978.

23. Reports on High-Income Taxpayers (sec. 2123 of the Act)

Prior law

The Secretary of the Treasury is directed (under sec. 6108 of the Code) to publish annually statistics compiled from tax returns, including classifications of taxpayers and of income, the amounts

[1] "An Act to insure that certain buildings financed with Federal funds are so designed and constructed as to be accessible to the physically handicapped," approved August 12, 1968 (82 Stat. 718; 42 U.S.C. 4151).

allowed as deductions, exemptions and credits and any other facts deemed pertinent and valuable.

Reasons for change

The statistics published by the Internal Revenue Service are an extremely valuable source of information for the analysis of tax policy. Generally, the Service has done an excellent job in computing and publishing their statistics.

In one respect, however, these statistics are misleading. They use "adjusted gross income" as the definition of an individual's income. This is a concept that is useful for purposes of computing the appropriate amount of income tax but is not a very good analytical measure of total income for purposes of determining a person's ability to pay income tax. This has led to considerable confusion about the extent to which high-income people are able to avoid paying income tax.

Adjusted gross income equals all gross income that is not specifically excluded from gross income minus (1) trade or business deductions (other than most such deductions by employees), (2) the deduction for alimony (which is made a deduction from gross income in this Act), (3) the deduction for one-half of long-term capital gains, (4) deductions for losses from the sale or exchange of property, (5) deductions attributable to rents and royalties, (6) the moving expense deduction, (7) deductions for contributions to individual retirement accounts, (8) deductions for contributions to H.R. 10 plans, and (9) certain other deductions.

Taxable income equals adjusted gross income minus itemized deductions (or, if the taxpayer so elects, the standard deduction) and the deduction for personal exemptions.

In recent years, the Internal Revenue Service has published statistics on the number of people with high adjusted gross incomes who paid no individual income tax. In 1974, for example, there were 244 people with adjusted gross income above $200,000 who paid no Federal income tax. There were 5 tax returns with adjusted gross income over $1 million and no Federal income tax liability.

The Congress believed that it is important to publish statistics on the extent of tax avoidance by high-income people, but that the statistics currently being published are deficient in several respects.

First, while most itemized deductions are for personal expenses and should not, therefore, be deducted in measuring total income for statistical purposes, some of them are business or investment expenses that should be deducted in properly measuring total income. The use of adjusted gross income as a statistical measure of total income means that no itemized deductions are allowed. One example of such a deduction that should be allowed is investment interest and expense, at least to the extent it offsets investment income. Another example is the deduction for employee business expenses.

Second, some of the types of income that are specifically excluded from gross income should be included in a proper statistical measurement of total income. These include, for example, interest on State and local government bonds and the first $100 of dividend income, both of which are tax exempt.

Third, some of the deductions allowed in arriving at adjusted gross income should not be deducted in defining a proper measure of total income. These include such items as the capital gains deduction and the deductions for contributions to individual retirement accounts and H.R. 10 plans.

Congress believed that the Internal Revenue Service should use the available data to obtain a more accurate estimate of how many high-income individuals are able to avoid paying income tax, what is the effective tax rate on the high-income group, and precisely what deductions are used by high-income people in avoiding tax. The Act, therefore, instructs the Secretary of the Treasury to publish statistics on tax liability of high-income individuals, using a definition of income that corresponds to a proper analytical measure of total income more closley than does adjusted gross income.

Explanation of provision

The Act instructs the Secretary of the Treasury to publish statistics on the tax liability of people with total incomes of $200,000 or more. These statistics should include the number and average income of high-income people with no income tax liability (after credits); the specific deductions, exclusions and credits used by these people to avoid tax; the number of high-income individuals; and the total income and tax liability of the high-income group.

For this purpose, income should be defined in a way that more closely approximates a proper analytical measure of total income than does adjusted gross income. This new concept of income should be derived from information that is now required to be listed on the tax return; Congress does not intend to complicate further the income tax return by adding new lines that are unnecessary for tax collection and are only designed to serve a statistical purpose. Being derived only from items already appearing on the tax return, this new measure of income will not itself be a comprehensive measure; but it will be better than adjusted gross income.

The new measure of income should include the following two adjustments: First, adjusted gross income should be reduced by investment interest and expense to the extent that it does not exceed investment income. Second, the items of tax preference under the minimum tax that are exclusions from gross income or deductions in arriving at adjusted gross income should be added back to adjusted gross income. The Secretary may also adjust for other items of tax preference for which data are available. These two adjustments are to be made separately, as well as together, so that the Act mandates statistics using three new definitions of income.

Congress does not intend that this provision add substantial cost to the Statistics of Income program. When data are not available to generate precise statistics, the Secretary should come as close as possible to making precise estimates of the relevant numbers.

Effective date

This provision is effective for Statistics of Income for 1975 and subsequent years. If data collection problems prevent full compliance for 1975 without substantial additional cost, the Secretary may make cruder estimates for 1975 than is intended for subsequent years.

Revenue effect

This provision will have no impact upon Federal revenues.

24. Tax Treatment of Certified Historic Structures (sec. 2124 of the Act and sec. 191 of the Code)

Prior law

The original users of depreciable real property constructed after July 24, 1969, are allowed to depreciate the property using accelerated methods of depreciation, including the 150 percent declining balance method (200 percent in the case of residential rental property). Accelerated depreciation methods are generally not allowable with respect to used property acquired after July 24, 1969. A 125 percent declining-balance method may be employed to depreciate used residential property with a useful life of 20 years or more at the time of acquisition. Ordinarily, the costs of rehabilitating an existing structure must be capitalized and depreciated according to the method used to depreciate the structure.

Generally, the expenses of demolishing an old building, and the remaining undepreciated basis of the demolished building, are deductible unless the building was acquired with a view toward its demolition.

Under prior law, a charitable deduction was not allowed for a contribution to charity (not in trust) of less than the taxpayer's entire interest in the property unless it was a contribution of an undivided interest in the property, a contribution which would have been entitled to a charitable deduction if it had been made in trust, or a contribution of a remainder interest in real property consisting of personal residences or farms.

Reasons for change

Congress believes that the rehabilitation and preservation of historic structures and neighborhoods is an important national goal. Congress believes that the achievement of this goal is largely dependent upon whether private funds can be enlisted in the preservation movement. Tax considerations have an important bearing on whether private interests are willing to maintain and rehabilitate historic structures rather than allow them to deteriorate or replace them with new buildings. It has been argued that certain tax provisions of prior law encouraged the demolition and replacement of old buildings instead of their rehabilitation. In particular, it has been argued that discrimination against preservation efforts existed under prior law because (1) the expenses of demolishing an old building and the remaining undepreciated basis of the demolished building were deductible unless the building had been acquired with a view towards its demolition and (2) more favorable depreciation methods were allowed with respect to expenditures incurred in the construction of new structures than those incurred in the rehabilitation of existing structures. Because of the adverse effect that these provisions of prior law may have had on the preservation of historic structures, Congress decided that the tax advantages of demolishing historic structures and of building replacement structures should be reduced. In addition, Congress decided to create an incentive for historic preservation by providing accelerated depreciation and rapid amortization for expenses incurred in the rehabilitation of historic structures.

Explanation of provisions

The Act allows taxpayers an election, in lieu of claiming the depreciation deductions otherwise allowable, to amortize over a 60-month period the capital expenditures incurred in a certified rehabilitation of a certified historic structure. Amortization is to be recaptured as ordinary income on a sale of the property. A "certified historic structure" is defined as a building or structure on which depreciation is allowable and which is (a) listed in the National Register, (b) located in a Registered Historic District and is certified by the Secretary of the Interior as being of historic significance to the district, or (c) located in a historic district designated under a State or local statute containing criteria satisfactory to the Secretary of the Interior. A "certified rehabilitation" is defined to be any rehabilitation of a certified historic structure which the Secretary of the Interior has certified as being consistent with the historic character of such property or district.

Alternatively, the Act allows taxpayers an election to be treated for depreciation purposes as if they were the original users of a "substantially rehabilitated historic property" (with the result that they would be allowed to use the 150 percent (or 200 percent in the case of residential rental property) declining-balance method of depreciation with respect to the entire basis of any such rehabilitated property on which depreciation was allowable). A "substantially rehabilitated historic property" is defined to be any certified historic property if the capital expenditures incurred in the certified rehabilitation of the property during the 24-month period ending on the last day of the taxable year exceed the greater of (1) the taxpayer's adjusted basis in the structure on the first day of the 24-month period or (2) $5,000. This election to use accelerated depreciation must be made with respect to the entire structure. A taxpayer cannot elect 5-year amortization with respect to certain components of a structure and accelerated depreciation with respect to others.

The Act provides that in case of the demolition of a certified historic structure, or of any other structure in a Registered Historic District unless certified by the Secretary of the Interior prior to its demolition not to be of historic significance to the district, no deduction is to be allowed for (1) the amount expended for its demolition or (2) any loss sustained on account of the demolition. Deductions disallowed under this provision are to be treated as chargeable to the capital account with respect to the land on which the demolished structure was located, and thus are not to be includible in the depreciable basis of any replacement structure.

The Act also provides that accelerated depreciation methods are not allowed with respect to real property constructed on a site which had been occupied by a certified historic structure which was demolished or substantially altered (other than by virtue of a certified rehabilitation).

Under the Act, a deduction is allowed for the contribution to a charitable organization exclusively for "conservation purposes" of (1) a lease on, option to purchase, or easement with respect to real property of not less than 30 years' duration or (2) a remainder interest in real property. For this purpose, a charitable contribution includes a contribution to a governmental unit. The term "conservation purposes" is defined to mean the preservation of land areas for public outdoor recreation or education, or for scenic enjoyment, the preservation of historically important land areas or structures, or the preservation of natural environmental systems. Such contributions also qualify as charitable contributions for estate and gift tax purposes.

Effective date

The five-year amortization of certified rehabilitation expenses applies to additions to capital account after June 14, 1976, and before June 15, 1981. Accelerated depreciation of substantially rehabilitated historic property applies to additions to the capital account after June 30, 1976, and before July 1, 1981. The disallowance of deductions with respect to demolitions of historic structures applies to demolitions commencing after June 30, 1976, and before January 1, 1981. The required use of straight line depreciation on replacement structures applies to additions to the capital account after December 31, 1975, and before June 15, 1981. The deductions are allowable for charitable contributions and transfers for conservation purposes made after June 13, 1976, and before June 14, 1977.

Revenue effect

It is estimated that these provisions will result in a revenue loss of \$1 million in fiscal 1977, \$3 million in fiscal 1978, and \$16 million in fiscal 1981.

25. Supplemental Security Income for Victims of Certain Natural Disasters (sec. 2125 of the Act)

Prior law

In general a recipient of supplemental security income living in someone else's household has his benefits reduced by one-third to reflect a lower level of need. However, Public Law 94–331 eliminates for up to 6 months the one-third reduction in the case of individuals displaced as a result of a major disaster occurring between June 1, 1976 and December 31, 1976.

Reasons for change

The 6-month period provided for in prior law proved to be an adequate period of time for victims of the flood disasters occurring in the last half of 1976 to relocate. Consequently, many of these victims faced a reduction in SSI benefits as of the end of 1976.

Explanation of provision

The Act extends the period during which the one-third reduction in SSI benefits may be suspended for these disaster victims from 6 months to 18 months.

Effective date

The provision is effective upon enactment.

Revenue effect

This provision has no effect on budget receipts.

26. Net Operating Loss Carryovers for Cuban Expropriation Losses (sec. 2126 of the Act and sec. 172(b) of the Code)

Prior law

Under prior law, a taxpayer could carry over a net operating loss attributable to Cuban expropriation to each of 15 taxable years following the taxable year of the loss.

Reasons for change

An original 10-year carryover period for Cuban expropriations was extended 5 years in 1971 by Public Law 91–677. This alleviated but did not correct the inequity for people who sustained losses but could not offset them because they were generating small annual incomes. The Internal Revenue Service estimates that there are a few hundred claims with losses remaining to be carried forward. These Cuban expropriation losses had to be claimed prior to December 31, 1965. They have been investigated and accepted by the Internal Revenue Service as actual losses.

The period was first extended to permit the use of the losses sustained. Since there are still some who have not had that chance, particularly those people least able to reestablish themselves, the Congress believes it is appropriate that an additional extension be provided.

The provision as amended applies to a decreasing number of persons, and their losses are not among the largest Cuban losses. These businessmen are, in many cases, finally generating income that will allow them to carry forward their losses.

Explanation of provision

The Act extends the carryover period for five years to 20 taxable years following the loss. The Congress intends this to be the final extension of the provision.

Effective date

This amendment is effective upon enactment.

Revenue effect

The revenue effect of this amendment is expected to be negligible.

27. Outdoor Advertising Displays (sec. 2127 of the bill and sec. 1033 (g) of the Code)

Prior law

Statutory rules provide that gains from involuntary conversions of property (including casualties and condemnations) are, in general, allowed nonrecognition treatment where money realized from the involuntary conversion is reinvested, within a limited period of time, in property which is similar or related in serv or use to the property converted (sec. 1033). A special rule has also been provided for condemnations of business or investment real estate (other than inventory property) under which more liberal rules are adopted for purposes of determining whether a purchase of replacement real estate qualifies as similar or related in service or use to the property converted (sec. 1033(g)).

The Internal Revenue Service has ruled that outdoor advertising billboards and displays are real property for purposes of the investment credit and depreciation recapture.[1] However, this administrative interpretation has been successfully challenged in several court cases which hold that billboards are tangible personal property (and not real property) for purposes of the investment credit.[2]

[1] Rev. Rul. 68–62, 1968–1 C.B. 365.
[2] See, e.g., *Alabama Displays, Inc. et al.* v. *United States*, 507 F.2d 844 (Ct. Cls. 1974): *Whiteco Industries, Inc.*, 65 T.C. 664 (1975).

Reasons for change

The Federal Highway Beautification Act of 1965 and State highway beautification statutes authorize the government to condemn and purchase privately owned highway billboards. Because of continuing restrictions on where highway billboards may be located, the former owners of condemned billboards (particularly small companies) are prevented from using their condemnation awards to build and situate replacement billboards; these taxpayers have been forced instead to reinvest their awards in other types of property. At the time the Congress enacted the highway beautification legislation it was anticipated that the IRS would permit taxpayers whose billboards were condemned to invest in other types of real property without payment of tax. However, the recent court decisions involving the classification of billboards as tangible personal property for investment credit purposes have put that determination in jeopardy. Thus, in order to permit reinvestments of billboard condemnation proceeds to qualify for tax-free treatment under the involuntary conversion rules in appropriate circumstances, while still not affecting the recent court decisions, Congress decided to allow taxpayers an election to treat outdoor advertising displays as real property.

Explanation of provisions

Under these provisions, an election is provided for taxpayers to treat outdoor advertising displays as real property. This election, once made, is irrevocable without the permission of the Secretary to change it and applies to all qualifying outdoor advertising displays of the taxpayer. The availability of this election should not be interpreted to prevent owners of outdoor advertising displays who do not make an election from claiming treatment for them as personal property.

Outdoor advertising displays do not qualify for the election where the taxpayer has previously treated the property as tangible personal property (by claiming either the investment credit or additional first-year depreciation). This limitation is necessary to prevent a taxpayer from treating the same property as tangible personal property for purposes of the investment credit and as real property for purposes of the involuntary conversion replacement property and depreciation recapture rules.

The term "outdoor advertising display" includes rigidly assembled outdoor signs and displays which are attached to the ground, a building, or other permanent structure for purposes of displaying advertising messages to the public. This term includes highway billboards attached to the ground with wood or metal poles, pipes or beams, with or without concrete footings.

The Act also provides that replacement real property will be considered "like kind" property even though a taxpayer's interest in the replacement property is different from the real property interest held in a qualified outdoor advertising display which was involuntarily converted. This is to enable, for example, purchases of replacement property to qualify under section 1033(g) even though a fee simple interest in real estate is acquired to replace in part a billboard owner's leasehold interest in real property on which the billboard was located.

Effective date

These provisions apply to taxable years beginning after December 31, 1970. It is contemplated that the Secretary will allow taxpayers who have previously made replacements of qualified outdoor advertising displays during closed taxable years a sufficient period of time to make an election for these closed years.

Revenue effect

It is estimated that this provision will have no appreciable effect on budget receipts.

28. Tax Treatment of Large Cigars (sec. 2128 of the Act and secs. 5701(a), 5702, and 5741 of the Code)

Prior law

Under prior law (sec. 5701(a)(2)), the manufacturers excise tax on large cigars (those weighing more than 3 pounds per thousand cigars) was imposed on the basis of a bracket system with the rate of tax dependent on the retail price of the cigar. The brackets were as follows:

Intended retail price per cigar (in cents)		
Over—	Not over—	Tax per thousand
0	2½	$2.50
2½	4	3.00
4	6	4.00
6	8	7.00
8	15	10.00
15	20	15.00
20		20.00

The retail price of a cigar was defined for Federal tax purposes as "the ordinary retail price of a single cigar in its principal market." The law provided that any State or local tax imposed on cigars as a commodity was to be excluded when determining the ordinary retail price.

Reasons for change

The prior bracket system was arbitrary in that it produced widely varying effective rates of tax depending on the retail price of the cigar. For cigars intended to retail for 20 cents each or less, the effective rate of tax depended on a combination of the rate of tax for the given bracket in which they fall and the price of the cigar. Thus, in the wide bracket covering cigars intended to retail for over 8 cents and not over 15 cents, the tax rate of $10 per thousand varied from a maximum of 12 percent of the intended retail price (including the tax) for cigars priced at three for 25 cents to a minimum of 6.7 percent for cigars intended to retail for 15 cents each. This 6.7-percent minimum effective rate also applied to cigars at the top of the over 4 cents and not over 6 cents bracket. However, in the over 6 cents and not over 8 cents bracket, the minimum effective rate was 8.8 percent. At the very bottom of the tax scale (namely, in the case of cigars intended to retail for not more than 2½ cents each), the tax of $2.50 per thousand imposed an effective rate of 10 percent of the retail price for cigars intended to retail at two for 5 cents.

A corollary of the variability of the effective rates of tax was the fact that a shift in the price of a cigar from the top of one bracket to the bottom of the next tax bracket could result in a tax increase disproportionate to the price increase. An example of this was the increase in tax from $4 to $7 per thousand between cigars intended to retail for 6 cents and those intended to retail for more than 6 cents and not over 8 cents. At the 6-cent level, the tax was 6.7 percent of the retail price and 10.4 percent of the manufacturer's net price (exclusive of tax).[1] If the manufacturer of a 6-cent cigar raised the stated retail price to three for 20 cents, the effective rate of tax would have increased to 10.5 percent of the retail price and 17.5 percent of the manufacturer's net price. The manufacturer would have netted only $1.70 more per thousand cigars although consumers would pay $6.67 additional. This bracket system not only discriminated among producers depending on the price at which they sold their cigars within a bracket but also prevented manufacturers from freely adjusting prices to meet cost changes.

There is no way to determine precisely how the burden of the cigar tax is distributed between consumers and owners of manufacturing firms. In either event, however, the prior tax was discriminatory. To the extent it is borne by consumers, the burden imposed by the tax varied erratically depending on the intended retail price of the cigars purchased. To the extent it is borne by manufacturers, the burden of the tax varied depending on the particular price lines produced by each manufacturer. As a percent of sales, the tax paid was least for those manufacturers whose production is concentrated in price classes where the effective rate of tax is at a minimum.

These problems of the bracket system have been recognized for a long time by the cigar industry, the Treasury Department, and the Congress. When the tax on cigars was collected by means of the purchase of stamps, practical consideration favored the use of some type of bracket system in order to keep to a reasonable level the number and denomination of stamps that had to be printed. However, the use of stamps as evidence of payment of tax was discontinued in June 1959. As a result, there was no reason why the bracket system should not be eliminated.

A change from a tax base of the intended retail price to a base of the intended wholesale price makes administration of the tax easier and avoids many of the problems associated with the prior tax base of the intended retail price in the cigar's principal market. Administration of the tax will be facilitated because wholesalers traditionally sell a given cigar at the same price to different retailers. Retail prices do not have this consistency. In addition, verification that sales actually take place at the list price will be easier than in the case of the intended retail price because there are far fewer wholesalers than retailers.

With a tax based on the wholesale price rather than the retail price, a rate of 10 percent is required in order to produce the same tax yield as is produced under prior law. However, if a substantial tax increase is not to result for many cigars, a rate which is lower than this is required. Substitution of an ad valorem rate of tax for the prior bracket

[1] This assumes the usual standard markup in determining the retail price.

system, of necessity, has a differing impact on individual firms within the cigar manufacturing industry.

An ad valorem rate set at 10 percent of the wholesale price would mean that those firms which have produced cigars which sold at prices where the tax rate was relatively low under the bracket system would be faced with a tax increase with such a rate. Firms producing cigars at prices where the tax rate has been relatively high under the bracket system, of course, would obtain some benefit under a 10-percent rate structure. In a transition of this type, however, in order to prevent a tax increase for a large number of lines of cigars, a reduction in the average rate of tax is necessary.

In addition to the need for a tax rate decrease because of a shift to an ad valorem system, a decrease in the rate of tax for cigars also is justified for other reasons as well, First, when many excise taxes were reduced or eliminated in 1965, the tax on cigars was nevertheless maintained at preexisting rates. Second, the cigar industry in recent years has been experiencing considerable financial difficulty. Sales have dropped dramatically from 9 billion cigars in 1964 to about 6 billion in 1975—a period of rising costs.

Explanation of provision

The Act changes the prior law tax on large cigars (those weighing more than 3 pounds per thousand [2]) to a tax of 8½ percent of the wholesale price, but not more than $20 per thousand cigars.

Wholesale price, as defined in the Act, means the manufacturer's or importer's suggested delivered price of the cigar to retailers (including in this price this Federal cigar tax). This price is to be determined before any trade, cash, or other discounts, or any promotion, advertising, display, or similar allowances. Generally, this wholesale price is the traditional manufacturer's or importer's declared intended catalog or list delivered bulk price to retailers. Where the manufacturer or importer has no suggested delivered price to retailers for the particular cigar in question (as may happen, for example, if he sells only at retail, or where the suggested delivered price to retailers is not adequately supported by bona fide arm's length sales), the Act provides that the wholesale price is to be determined by the Treasury Department on the basis of the price for which cigars of comparable retail price are sold to retailers in the ordinary course of trade.

In most cases the wholesale price will be adequately supported by sales by the wholesalers to retailers. In only a few situations will it be necessary for the Treasury Department to determine the wholesale price on the basis of the price for which cigars of the same or comparable retail price are sold to retailers in the ordinary course of trade.

The use of the intended wholesale price as the tax base will eliminate the troublesome determination of the retail price of a single cigar in its principal market.

The wholesale price does not include State or local taxes imposed on cigars as a commodity. The prior law exclusion of such taxes from the tax base is continued by this provision. If a manufacturer normally includes State or local taxes in his "wholesale price," he must

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[2] Small cigars are not taxed on the basis of price. Their tax rate is 75 cents per thousand.

show the price net of any such taxes in a manner satisfactory to the Treasury Department for the purpose of imposing the tax provided by the Act.

The Act also amends the Code (sec. 5741) to include importers among those persons required to keep records prescribed by the Treasury Department and to provide that the required records be available for inspection by internal revenue officers during business hours. The existing statutory requirement is extended to importers in order to avoid any doubt that appropriately prescribed regulations may require them to keep records which are needed. This is particularly relevant with the change in manner of imposition of the tax on large cigars and the added definition of "wholesale price" which will likely result in a requirement that records be kept by importers.

Effective date

The new ad valorem tax becomes effective on the first day of the first month which begins more than 90 days after the date of enactment of the Act (i.e., February 1, 1977).

Revenue effect

This provision will reduce budget receipts by $7 million in fiscal year 1977, $7 million in fiscal year 1978, and $7 million in fiscal year 1981.

29. Treatment of Gain from Sales or Exchanges Between Related Parties (sec. 2129 of the Act and sec. 1239 of the Code)

Prior law

Under prior law, recognized gains from a sale or exchange of depreciable property were denied capital gain treatment (and taxed as ordinary income) if the transaction was between a husband and wife, or between an individual and a corporation over 80 percent of the value of whose stock was owned by the individual, his spouse, and his minor children or grandchildren (sec. 1239). This rule applied where the shareholder sold property to his controlled corporation, or vice versa.

Although the statute covered a sale or exchange "directly or indirectly" between an individual and a controlled corporation, several courts had held that this language does not reach gain on a sale of depreciable property between two corporations each of which is more than 80 percent controlled by the same individual and his family. These courts refused to follow a ruling by the Internal Revenue Service that a sale between two such commonly controlled corporations is (for purposes of this provision) "indirectly" a sale between the individual and the corporation.[1]

Reasons for change

In enacting section 1239 (and its predecessors in the 1939 Code), Congress sought to prevent the practice of selling a low basis-high value depreciable asset to a controlled corporation in order to "step up" the basis of the asset for depreciation purposes in the hands of the corporation at the cost of a capital gain tax to the selling share-

[1] Rev. Rul. 69-109, 1969-1 C.B. 202.

holder.[2] The corporation's basis would be its cost for the property, which in turn would reflect appreciation in value in the hands of the shareholder.

In refusing to interpret "indirectly" to cover commonly controlled corporations, the courts did not disagree that corporations under common control can and do engage in sales or exchanges with each other to obtain tax benefits which Congress wanted to deny if the sale were made directly between the shareholder and the corporation. The courts, however, generally based their decisions on technical factors involving the language of the statute and ambiguity in the legislative history of the provision.

The potential for abuse is as evident in such cases, however, as in direct sales between a shareholder and his controlled corporation. In both situations, the shareholder (or his family) maintains control over the asset while the corporation obtains a higher depreciable basis in the property. Congress sees no reason why a sale between corporations controlled by the same individual should be treated differently from a sale between an individual and his controlled corporation.[3]

No rules of constructive ownership were formerly provided in section 1239 for purposes of determining the ownership of stock under that provision. As a result, a taxpayer could structure a transaction to circumvent the section. For example, a taxpayer desiring to sell depreciable property to a corporation which he wholly owned could avoid section 1239 by (prior to the sale) contributing his stock in the corporation to a holding company or by transferring 20 percent of his stock to a trust for the benefit of members of his family. Although it could be argued that the taxpayer continued to own the stock "indirectly" and section 1239 therefore should come into play, the courts (as indicated) were reluctant to give a broad interpretation to the term "indirectly."

Explanation of provision

The Act strengthens section 1239 in several ways. First, a new rule brings within the scope of this provision a sale or exchange of depreciable property between commonly-controlled corporations. Another new rule makes the rules of constructive ownership applicable in determining stock ownership under this provision generally. For this purpose, the present rules which apply under section 318 are incorporated by reference. Third, the Act changes the control requirement which brings section 1239 into effect from over 80 percent to 80 percent or more in value of a corporation's stock.

Under the first of these changes, the treatment of gain as ordinary income in the case of a sale between commonly controlled corporations occurs at the level of the transferor (seller) corporation rather than at the level of the shareholder. The constructive owner-

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[2] H. Rept. 586, 82d Cong., 1st Sess. (1951), 1951–1 C.B. 357, 376. The committee report states that this type of transaction may be highly advantageous "when the sale may be carried out without loss of control over the asset because the corporation to which the asset is sold is controlled by the individuals who make the sale."

[3] The depreciation recapture rules of sections 1245 and 1250 would have a limited use to prevent this abuse where sales are made (between controlled corporations) of property which has a low basis but a high value. In such cases, sections 1245 and 1250 would in many cases recapture as ordinary income only a relatively small portion of the seller's gain.

ship rules are to be used to determine whether the 80 percent stock ownership requirement has been met, but (in the commonly controlled corporation situation) the actual tax effect of recharacterizing gain as ordinary income will occur at the corporate level.[4]

Congress does not intend, however, to prevent section 1239 from being invoked to produce ordinary income to a shareholder where a corporation is used as a conduit to make a sale to another controlled corporation, or where the entity of a corporate transferor can properly be disregarded for tax purposes. These situations will result in ordinary income to the shareholders.[5]

The incorporation of constructive ownership rules into section 1239 applies generally to this section. In light of the section 318 rules, the 80-percent requirement of section 1239 will continue to be measured by reference to the value of the company's outstanding stock; however, the stock which will be grouped together in measuring control will include stock considered owned by an individual under the constructive ownership rules. Thus, the Act broadens the constructive ownership rules which trigger the restrictions under this provision to include stock owned by the taxpayer's parents, his adult children, and by any trust, estate or partnership of which the taxpayer is a beneficiary or partner. For example, if a father-owns outright 79 percent of the stock (by value) of a closely held corporation and a trust for his children owns the remaining 21 percent of the stock, the children will be deemed to own the stock owned for their benefit by the trust in proportion to their actuarial interests in the trust (sec. 318(a)(2)(B)). The father will, in turn, constructively own the stock so deemed to be owned by his children (sec. 318(a)(1)(A)(ii)). The result will be that the father will be treated as owning all the stock of the corporation, and any gain he would otherwise have to recognize from selling depreciable property to the corporation will be treated by section 1239 (as amended) as ordinary income.

Another effect of the constructive ownership rules is that in some cases section 1239 can now produce ordinary income to a parent corporation which sells depreciable property at a gain to an 80 percent or greater controlled subsidiary. If one or more related individuals own at least 80 percent of the value of the parent company's stock, the same shareholders will now also own constructively the stock in the subsidiary owned by the parent; as a result, the same individual or individuals will own 80 percent or more in value of the stock of two or more corporations and a sale between the two corporations will be governed by section 1239.

The constructive ownership rules also mean, among other things, that if a shareholder holds an option to acquire stock (such as from

[4] If the transferor corporation is a subchapter S corporation (i.e., a corporation which has made an election under sections 1371–1379), gain which is denied capital gain treatment by reason of the Act will be included in the corporation's undistributed taxable income which is taxed to its shareholders (pursuant to sec. 1373 of the Code).

[5] The new rule bringing sales between certain controlled corporations within section 1239 also is not intended to make such sales less subject than they were under prior law to allocations of income between or among the corporations or their shareholders under section 482. Nor is the new rule intended to make such sales no longer subject to constructive dividend treatment to the controlling shareholder (as may occur in appropriate cases under present law).

another shareholder), he will be treated as owning the stock which he could acquire by exercising the option (sec. 318(a)(4)).[6]

Effective date

These new rules apply to gain recognized on a sale or exchange made after the date of enactment of the Act (October 4, 1976). A transition rule provides that the new rules will not apply to a sale or exchange made after the date of enactment but occurring pursuant to a binding contract entered into before the date of enactment.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of less than $5 million annually.

30. Application of Section 117 to Certain Education Programs for Members of the Uniformed Services (sec. 2130 of the Act)

Prior law

Amounts received by an individual as a scholarship at a qualified educational institution (as defined in sec. 151(e)(4)) or as a fellowship grant for study, research, etc., are generally excluded from gross income (sec. 117(a)). However, such amounts are not excludible from gross income if they represent compensation for past, present, or future employment services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor (Treas. Regs. § 1.117-4(c)).

However, prior law contained a special exclusion for amounts received under the Armed Forces Health Professions Scholarship Program. During calendar years 1973, 1974, and 1975, amounts received from appropriated funds as a scholarship (including the value of contributed services and accommodations) by a member of a uniformed service [1] who was receiving training under the Armed Forces Health Professions Scholarship Program [2] (or any other similar program, as determined by the Secretary of the Treasury) were specifically excluded from gross income by congressional action.[3] This exclusion was available whether the member was receiving training while on active duty or in an off-duty or inactive status, and without regard to whether a period of active duty was required of the member as a condition of receiving those payments.

Reasons for change

The Internal Revenue Service had ruled (Rev. Rul. 76-99, 1976-1 C.B. 40) that without further legislation, all amounts received under

[6] As another example of the effect of the stock attribution rules, assume that a shareholder owns 80 percent of corporations *A* and *B*. The shareholder attempts to plan around the rule in the Act bringing sales between controlled corporations within section 1239 by contributing his stock in corporation *B* to newly formed holding company *C*, which the shareholder wholly owns, and then having *A* sell depreciable property to *B* at a gain. Without attribution, this sale might be found not to be covered by section 1239. However, the attribution rules incorporated by the Act will treat the shareholder as owning the *B* stock owned by holding company *C*, so that *A*'s gain on the sale will be ordinary income.

For purposes of section 1239, attribution to a shareholder of stock owned by a corporation, or vice versa, is to occur without regard to the 50-percent limitations contained in sections 318(a)(2)(C) and 318(a)(3)(C).

[1] As defined under 37 U.S.C. 101(3).

[2] Authorized by the Uniformed Services Health Professions Revitalization Act of 1972 (10 U.S.C. 2120-2127).

[3] Public Law 93-483 (H.R. 12035; 93rd Congress, 1st Sess.), October 24, 1974.

the Armed Forces Health Professions Scholarship Program would be treated as compensation and therefore includible in gross income for calendar year 1976 and thereafter. In view of the congressional and executive branches' concern regarding the need for these health professions scholarships for the uniformed services, the Congress concluded that those scholarships would continue to be excluded from gross income pending a thorough staff review of the appropriate tax treatment of the grants in view of the overall national policy toward the military (and other uniformed services) health professions programs.[1]

Explanation of provision

The Act excludes from income in 1976, 1977, 1978, and 1979 amounts received under the Armed Forces Health Professions Scholarship Program (and similar programs) by a member of a uniformed services [2] participating in a program in 1976.

Effective date

This provision is effective for amounts received during calendar years 1976, 1977, 1978 and 1979 by persons participating in the programs in 1976.

Revenue effect

It is estimated that this provision will decrease budget receipts by $10 million in fiscal year 1977 and $8 million in both fiscal 1978 and fiscal 1979.

31. Exchange Funds (sec. 2131 of the Act and secs. 368, 584, 683 and 721 of the Code)

Prior law

An exchange fund is an investment entity through which large numbers of investors pool stocks or debt securities, which usually are highly appreciated, in exchange for shares of the fund. These arrangements allow investors to diversify their concentrated ownership of one or a few securities into a broader variety of other stocks and securities (usually publicly-traded interests in listed companies) without paying taxes on the appreciation which they realize at the time the different stocks are exchanged with the fund.

Present law does not permit tax-free formation of an exchange fund as a corporation where the result is a diversification of the investor's portfolio.[1] This restriction was added in 1966 after a period in the early 1960's when investment management firms publicly solicited individuals owning highly appreciated stocks or securities to pool their stocks tax-free in a newly formed corporation which would then manage the combined portfolio.

The 1966 legislation dealt only with swap funds in corporate form and did not deal with partnerships because, at that time, such funds could not operate in partnership form (largely because of securities

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[1] The House Committee on Ways and Means has indicated that it plans to study, with the Internal Revenue Service, the appropriate tax treatment of scholarships and fellowships (H. Rept. 94–658; November 12, 1975, p. 427).

[2] As defined under 37 U.S.C., Sec. 101(3).

[1] This restriction now appears as section 351(d) of the Code. See also Regulations § 1.351–1(c).

restrictions and state partnership problems). Recently, however, these difficulties were resolved and a number of public syndications were organized to sell exchange funds as partnerships. In April, 1975, the Internal Revenue Service granted a private ruling to the Vance, Sanders Exchange Fund which proposed to operate as a limited partnership, allowing investors to transfer appreciated stocks or securities to the fund without a current tax to the investor-limited partners. This ruling prompted the formation of other similar partnerships, including some which proposed to offer interests to investors privately (rather than by broad public solicitation). Several of these funds filed private ruling requests with the Service, which then suspended issuance of favorable rulings pending the outcome of legislation introduced to change the tax treatment of partnership exchange funds.

Under prior law, the transfer of property to a partnership by one or more persons in exchange for an interest in the partnership did not result in recognition of gain or loss (sec. 721).[2] This rule parallels the general corporate rule (sec. 351). except that a partner does not have to control the partnership immediately after the transfer. There was, however, no exception requiring recognition of gain on transfers of property to a partnership exchange fund.

Reasons for change

Congress concluded that the creation of exchange funds through partnerships (or through trusts or corporate reorganizations) should not receive taxfree gain treatment where the principal effect is to diversify a taxpayer's investment without current payment of tax. It appears to the Congress that the principal purpose of an exchange fund is to diversify the depositors' portfolios of highly appreciated stocks or securities without current payment of tax. If a depositor had instead liquidated his appreciated portfolio and invested the proceeds in a mutual fund or other diversified portfolio, a capital gain tax would be imposed on the gains in his own stocks. Even after joining an exchange fund, the investors also generally do not want the managers to sell off either their own or other stocks so as to trigger a large capital gain tax at an earlier time than would have occurred had the investors retained their own shares. This conclusion seems justified by the importance in a partnership "swap" fund of a mutually satisfactory selection and rejection of stocks by the managers and investors before the fund even begins operating. The partnership funds themselves advertise that they will have a low or minimal portfolio turnover rate.

This type of arrangement differs from a conventional partnership or corporation in which the owners of different assets pool them taxfree in order to share the risks of conducting an ongoing business. In substance, a swap fund does not conduct an ordinary investment business; instead, it "provides an investment medium consisting of a diversified and supervised portfolio of equity securities to investors holding blocks of individual equity securities with large unrealized appreciation, * * *."[3] In this light, Congress concluded that the original ex-

[2] The partner's basis in the property he contributes to the partnership becomes both his basis for his partnership interest (sec. 722) and the partnership's basis in the property it receives (sec. 723).

[3] Prospectus of Vance, Sanders Exchange Fund (January 5, 1976), p. 1.

change of appreciated stocks for shares of an exchange fund should properly be viewed as a taxable sale or exchange with other investors made through the fund.

Explanation of provision

Partnership exchange funds

The Act makes a specific exception to the general rule in section 721 of the Code relating to nonrecognition of gain or loss on a contribution of property to a partnership in exchange for an interest in the partnership. The exception operates where a partner transfers property to a partnership which is an "investment company." If the partnership is an investment company after the exchange, the contributing partner must recognize gain (if any) which he realizes on the exchange.[4] The Act thus requires the current taxation of gains realized by investors who transfer appreciated stocks or securities (or other property) to an exchange fund operated as a partnership.

The Act does not change the law with regard to losses, so that a loss realized on a contribution of stock or securities (or other property) to a partnership cannot be recognized at that time.

A partnership will be treated as an "investment company," for purposes of this provision, if it satisfies the definition of an investment company under the present rules relating to corporate exchange funds (sec. 351). The latter rules are set forth in detail in the regulations under section 351. In light of these regulations, a partnership will be treated as an investment company if, after the exchange, over 80 percent of the value of its assets (excluding cash and nonconvertible debt obligations) are held for investment and are readily marketable stock or securities (or are interests in regulated investment companies or real estate investment trusts). The diversification rules of the section 351 regulations are also intended to be incorporated under section 721 as an integral part of the definition of an investment company. Therefore, in order for the new special rule in section 721 to become operation, property transfers to a partnership must result in diversifying the transferors' interests in light of all the assets obtained by the partnership on the transfers. The determination of whether a partnership is an investment company under this test will ordinarily be made immediately after the transfers of property under the same plan or as part of the same transaction.[5] The amount and character of the gain which a partner must recognize under the Act are to be determined under the general provisions of present law.

These rules apply both to limited partnerships and general partnerships, regardless whether the partnership is privately formed

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[4] Consistent with this rule, a partner's basis for his partnership interest (under sec. 722) is to be increased by the amount of gain recognized on his transfer of property to the partnership. The partnership's basis in the property contributed to it (sec. 723) is also to be increased by the amount of gain which the contributing partner must recognize.

[5] Since nonrecognition under section 721 does not require that the transferor (either alone or as part of a group of transferors) control the partnership immidately after the exchange, gain on appreciated property will be taxable whether the property is transferred to a partnership investment company already in operation or one which is newly formed.

This amendment is not intended to change existing rules which permit the Service in appropriate situations to treat related contributions and distributions by a partnership having two or more partners as a direct taxable exchange among the partners (regulations § 1.731-1(c)(3)).

or publicly syndicated. They also require recognition of gain by a person who transfers nonpublicly-traded stocks or securities to a partnership which, after the transfer, meets the tests of an investment company.

As under the corporate rule, the property on which gain will be recognized is not limited to appreciated stocks or securities, but includes other types of property (such as real estate or other assets) if the partnership which receives the property is an investment company after the exchange.

Under the new provision, and except as provided below, a partnership may still be an investment company despite the existence of a special allocation among the partners as to income, gain, loss, or deduction items (sec. 704). In some situations, however, it might be proper to find that no diversification has occurred if the partnership agreement allocates income and gains (or losses) from specific property to the contributing partner and requires that a withdrawing partner be returned the property which he contributed originally.[6]

These provisions will not affect the tax treatment of an investment partnership as a partnership for tax purposes; that is, whether it will be taxable as a partnership or as a corporate-type entity. That classification question will continue to be determined under section 7701 of the Code.

Effective date.—The provisions for partnership exchange funds apply generally to transfers made to a partnership after February 17, 1976. This general rule applies where the final binding exchange of deposited securities for interests in the fund is consummated after February 17, 1976, and the partnership becomes the owner of the deposited stocks and securities. Except as indicated below, this general rule applies in a situation where stocks or securities were deposited with a depository bank on or before February 17, 1976, but where the actual exchange with the fund occurs after that date.

"*Grandfather*" *rules.*—Congress was informed that several partnership exchange funds were in various stages of being organized or completed when legislation in this area was introduced in the House. One fund, the Vance Sanders Exchange Fund, had already obtained a private ruling from the Internal Revenue Service approving its formation as an exchange fund. By February 17, 1976 (when legislation was first introduced), other partnerships had taken substantial steps toward establishing an exchange fund by applying for a tax ruling, registering their proposed offering with the Securities and Exchange Commission, lining up brokers and dealer-managers, or soliciting expressions of interest from potential depositors.

The Act contains "grandfather" rules for these other funds under which the general effective date does not apply to completed transfers of property to a partnership after February 17, 1976, if, on or before March 26, 1976, the partnership filed for (or received) a private ruling from the Internal Revenue Service relating to its character as an

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[6] The Treasury should provide by regulation that the members of a partnership which would be treated as an investment company are not eligible to make the election under section 761(a) not to be goverened by the partnership tax rules. Where a partnership would not be treated as an investment company under the new rules, however, because the transfers do not result in diversifying the transferors' interests, the partners should be entitled to make the election under section 761(a) to the extent the election would otherwise be available.

exchange fund,[7] or the partnership filed a registration statement (if required by the securities laws to do so) with the Securities and Exchange Commission.[8]

A partnership qualifying for grandfather treatment must also satisfy certain other limitations. First, there is a limit on the time period for the exchange. The final binding exchanges of deposited stocks or securities for interests in the partnership must occur on or before the 90th day after the date on which the Act becomes law. (The Act was signed by the President on October 4, 1976.) Exchanges under this rule may be consummated before the date of enactment of the provision, but qualifying exchanges must be completed no later than the end of the 90th day after enactment. Second, the stocks or securities exchanged must also have been deposited with the bank or other agent of the depositors on or before the 60th day after the date on which the Act became law.

The Act also places a dollar limit on the total size of the grandfathered funds. If stocks or securities had been deposited by February 29, 1976, the partnership may complete exchanges with investors of the entire dollar value of securities on deposit by that date (or a lesser sum if securities are withdrawn or rejected after the end of the deposit period). In the case of other funds which had not begun receiving deposits by February 29, 1976, the Act permits qualifying partnerships to make exchanges with depositors in the amount of the total dollar value of the deposited stocks on the 60th day after the Act became law (or if earlier, at the close of the fund's initial deposit period), up to a ceiling of $100 million per partnership ($25 million in the case of private offering). These valuation ceilings are to be determined on this 60th day (or, if earlier, on the last day of the fund's initial deposit period).

Trusts

In order to cover the possible use of trusts as exchange funds, the Act also adds a specific rule to the Code (new section 683) that gain, but not loss) will be recognized to the transferor on a transfer of property to a trust in exchange for an interest in other trust property where the trust would be an "investment company" (within the meaning of sec. 351) if the trust were a corporation. The hypothetical status of the trust as a corporation for purposes of new section 683 does not depend on the actual characteristics of the trust or on its being classifiable as an association taxable as a corporation under section 7701 of the Code.

Ordinarily, a transfer of property to a trust is not treated as a sale or other disposition of the property. Consequently a transferor of property to a trust is ordinarily not required to recognize gain or loss for income tax purposes. However, Congress concluded that it

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[7] A ruling from the Service relating to the basic classification of a partnership under section 7701 of the Code is not sufficient. To qualify, the ruling must have been based on the partnership's plan to operate as an investment company (within the meaning of that term in these provisions of the Act) and the ruling must have held that nonrecognition treatment can be obtained under section 721 of prior law.

[8] The March 26, 1976, date was the last business date preceding the hearings by the House Ways and Means Committee on legislation in this area.

Congress also intends that a partnership which submitted a ruling request with the Internal Revenue Service on or before March 26, 1976, to operate an exchange fund as a general partnership will also be included within the grandfather rule if, after the March 26 date and because of securities difficulties, it changes to a limited partnership similar to that used by other partnership exchange funds.

should not be possible to use a trust as a means of achieving the same advantages as a partnership exchange fund without recognition of gain when such a trust is initially formed.

Under the Act, an "exchange for an interest in other trust property" will occur, for example, where numerous persons transfer property to a trust and each person retains a proportionate ownership in all of the property held in the trust. Where a transfer to a trust is taxable under this provision, the entire amount of gain on all the property transferred to the trust will be recognized even though the transferor still beneficially owns a portion of the property transferred to the trust. Where the transferor retains less than his proportionate interest in the trust, it is expected that the Service will issue regulations determining when gain must be recognized and the amount of gain to be recognized by the transferor.

Where a transfer to a trust is taxable under this provision, the determination of the amount of gain to be recognized is to be made property-by-property. Thus, losses realized on one property will not reduce the amount of gain recognized under this provision on other property transferred to the trust.

This provision applies only to trusts which are subject to the rules governing normal trusts (subpart J of chapter 1 of the Code). Consequently, the provision does not apply to qualified employee benefit trusts or to charitable and other tax-exempt organizations which are organized as trusts (i.e., those trusts which are subject to subchapters D and F of chapter 1 of the Code).

In addition, the Act contains an exception from the above trust rules for transfers to a pooled income fund (as defined in section 642(c)(5)).[9]

Effective date.—The provisions relating to trusts are effective for transfers made after April 7, 1976.

Common trust funds

Congress was also concerned about the use of a bank's common trust fund as an exchange fund.[10] To cover this case, the Act amends sec. 584(e) of the Code to provide that the admission of a participant to a common trust fund is to be considered to be the purchase of, or an exchange for, a participating interest in the fund.

Where the consideration for the participating interest is cash, the transaction will be considered a purchase of a participating interest. In such a case, the participant will not recognize any gain because there has not been a sale or other disposition of property. Where the consideration for the participating interest is property, the transaction will be considered an "exchange" of the property for the participating interest. As a result, gain or loss will be realized under section 1001 by the participant on the transfer of property to the

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[9] Under existing law, a pooled income fund is treated as a trust (sec. 642(c)(5)). This type of fund is generally a trust established by a charity to receive transfers of property (including appreciated stocks or securities) from one or more donors who receive an income interest in the property with the remainder interest being transferred to the charity.

[10] Common trust funds are maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed to the common trust fund by the bank acting as trustee, executor, administrator or guardian of separate trusts. A common trust fund is not a separate taxable entity and its income is taxable to the separate funds participating in the common fund (see sec. 584). The Code contains no express rule, however, requiring recognition of gain or loss to a participant who contributes appreciated or depreciated property to a common trust fund.

common trust fund. This gain or loss must ordinarily be recognized to the participant (sec. 1001(c)) and, if the property transferred is a capital asset, the gain or loss will be capital gain or loss.

Congress was informed that the Comptroller of the Currency, who regulates these funds, generally requires that if an individual trust wants to join an existing common trust fund, appreciated stocks or securities owned by the trust must first be sold (sometimes to the common trust fund itself) and only the sale proceeds contributed to the fund. However, where a common trust fund is being formed initially, the Comptroller has on occasion permitted participants to transfer stocks or securities in kind to the fund. The Act will not affect transfers of cash to a common trust fund. It will, however require recognition of gain where the Comptroller permits a common trust fund to be created by contributions in kind, if the effect is to achieve a diversification of the transferrors' investment interests.

Congress also understands that in some situations when banks merge or otherwise reorganize with each other, the combining banks have also merged (and sometimes also divided) separate common trust funds formerly maintained by each bank. Congress was also informed that the Comptroller of the Currency requires a common trust fund to maintain a diversified portfolio which would readily satisfy the diversification test in the Act for corporate investment companies (as described below).

Since the Act permits a merger of corporate investment companies to continue to receive tax-free treatment if both companies are already diversified (see discussion below), a similar rule is implicit in the bill for common trust funds; namely, that mergers (or divisions) of common trust funds regulated by the Comptroller of the Currency will continue eligible for tax-free treatment if all the combining (or dividing) funds have diversified portfolios (within the meaning of the corporate merger rules of the Act).[11]

Effective date.—The amendment to the common trust fund rules is effective for transfers made after April 7, 1976.

Mergers of two or more investment companies

The Act adds an exception to the definition of a taxfree "reorganization" in prior law in order to require recognition of gain or loss on exchanges which, from an investor's standpoint, resemble the formation of an exchange fund. For example, a group of individuals each holding a few undiversified stocks cannot now pool their stocks directly in a corporate exchange fund. But they might be able to circumvent this rule if each individual could successfully place his own stocks in a new wholly-owned corporation and, after a sufficient (but planned) interval, merge all the corporations together under the rules of section 368. In effect, each investor would thereby achieve tax-free diversification of his investment assets. Other transactions have occurred in which conventional mutual funds have acquired in a tax-free reorganization assets or stock of an undiversified personal holding company (or other closely held investment corporation) owning a port-

[11] If diversified funds are merging (or dividing), Congress thus does not intend to treat the participating trusts or the separate funds as being "admitted" to the surviving (or divided) fund in order to make the merger or division taxable by reason of the amendment of section 584.

folio of stocks or securities.[12] In some cases these acquisitions are prompted by business reasons; however, in most cases the principal effect (if not also the main purpose) of these transactions is the diversifying of investment assets while the appreciation goes untaxed to the transferors.

The Act requires recognition of gain or loss on a statutory merger or other exchange of assets or stock of an undiversified investment company (as specifically defined in the Act) if the result of the exchange is to achieve significantly more diversity for the shareholders of that company than existed before the exchange. The Act continues to allow nonrecognition treatment generally for reorganizations, however. Also, if two or more investment companies (or their shareholders) participate in an exchange, the transaction will continue to be eligible for tax-free reorganization treatment if both companies have diversified portfolios before the exchange.

More specifically, if the parties to an exchange otherwise described in the tax-free reorganization provisions (under sec. 368(a)(1)) include two or more "investment companies," the exchange will not qualify for customary reorganization treatment as to one or more of the investment companies and their shareholders and security holders if that company owned a relatively undiversified portfolio of stock or securities before the exchange.

This rule will disqualify only the portion of the entire transaction involving the undiversified investment company and its shareholders and security holders. The tax result will be that that portion of the entire transaction will be treated as a "taxable" sale and purchase of assets or stock with the customary tax results to both seller and buyer of such a recognition transaction.[13] For example, if two undiversified investment companies and a corporation predominately engaged in an active business combine in a statutory consolidation, the new rule treats each acquired investment company as if it had sold its assets in a taxable transaction, i.e., one in which gain or loss is recognized currently.[14] In most situations, this rule will also treat each shareholder of each undiversified investment company as if he had made a taxable exchange of his former stock interest for stock in the acquiring company.[15] The merger of the operating company's assets under the same plan, however, could qualify under the customary reorganization rules.

Definition of "investment company."—The Act defines an investment company (for purposes of the reorganization rule) as (1) a

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[12] The Service approved a transaction of this kind in Rev. Rul. 74–155, 1974–2 Cum. Bull. 86.

[13] The acquiring company will thus take a cost basis (rather than a carryover basis) in the assets or stock acquired. There will be no carryover to the acquiring company of tax items under section 381 of present law with regard to the portion of the transaction which is denied reorganization status. The shareholders and security holders of an undiversified investment company which participates in a reorganization made taxable under the Act will also be denied the customary nonrecognition treatment under section 354 of the Code.

[14] The new rules take no position on the question whether the provisions of section 337 are available to the acquired company where a transfer of its assets fails to qualify for nonrecognition treatment under section 361. Section 337 provides nonrecognition treatment to a corporation which sells its assets and liquidates completely within 12 months after adopting a plan of complete liquidation. The possible application of section 337 is to be determined under existing law.

[15] Where a shareholder of an undiversified investment company exchanges his stock solely for voting stock of a diversified investment company in an exchange otherwise described in sec. 368(a)(1)(B), the effect of disqualifying that exchange for tax-free treatment will be to treat the shareholder of the undiversified company as having sold his stock in a taxable exchange.

regulated investment company, (2) a real estate investment trust, or (3) a corporation over 50 percent of the value of whose total assets consists of stocks or securities and, in addition, over 80 percent of the value of whose total assets are held for investment.[16] Investment assets in the 80-percent category include stocks or securities as well as other kinds of property held for investment purposes. A company which fits within any of the above three classes is regarded as an investment company for purposes of the reorganization rule.[17]

It is important to distinguish (in defining an investment company) between corporations involved in relatively passive management of portfolio assets as an investment and holding companies (including so-called conglomerates) which render management services to operating business companies in which it (the parent company) usually owns the controlling stock. The Act provides that in applying the 50-percent and 80-percent asset tests (to determine whether a corporation is an "investment company"), a corporation will be deemed to own directly its proportionate share of the assets of a subsidiary corporation in which the parent owns 50 percent or more of the combined voting power of all voting stock of the subsidiary or 50 percent or more of the total value of all classes of the subsidiary's outstanding stock.[18]

In determining a corporation's "total assets" under the 50-percent and 80-percent tests, cash and cash items (including receivables) are excluded from the calculation (sec. 368(a)(2)(F)(iv)). U.S. Government securities are also excluded from both the numerator and denominator in this calculation.

A further rule aims at preventing manipulation of a company's assets in order to make one or more of the parties fail to be an "investment company" (and therefore free of the Act's restrictions). Assets acquired by a corporation for purposes of causing that corporation not to be an "investment company" are to be disregarded in determining whether that corporation is an investment company immediately before the transaction. This rule is not, however, intended to affect situations where a corporation purchases or otherwise acquires

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[16] Congress believes that for purposes of this provision the term "securities" should include obligations of State and local governments (including industrial development bonds), stock warrants, stock options and rights, commodity futures, mutual fund shares (both open and closed end), interests in real estate investment trust, commercial paper, corporate notes (whether or not secured by an interest in real property), participating interests in Federally guaranteed or insured mortgage or other loan pools, and interests in partnerships the sale of which are required to be registered with the Securities and Exchange Commission or State securities offices.

The types of stocks and securities to be taken into account under this third category of investment company include closely held and publicly traded investments (i.e., the latter covering stocks traded on a stock exchange or over-the-counter, or which are otherwise readily marketable).

[17] An investment company for this purpose does not have to be technically a "personal holding company" within the meaning of section 542 of present law. The nature of the shareholders of the investment company is also immaterial in applying these rules.

[18] To illustrate, suppose that all the assets of holding company *X* consist of directly-owned investment assets of $30,000; small amounts of stock in publicly held company *A* worth $30,000 and in public company *B* worth $25,000; and over 50 percent of the stock of operating company *C* to which *X* provides management services. The value of *X*'s stock in *C* is $15,000, reflecting its allocable share of *C*'s net assets. *C* owns no investment assets. The value of *X*'s ratable share of *C*'s "total assets" (not reduced by liabilities) is $70,000.

Under the Act, since *X* owns 50 percent or more of *C*, *X* will be deemed to own $70,000 of *C's* total assets directly (in lieu of its stock interest in C). As such, *X* will not be an investment company since less than half of its total assets will be deemed invested in portfolio stocks ($55,000/$155,000). Also, less than 80 percent of *X*'s total assets will be treated as held for investment ($85,000/$155,000).

If there were no look-through rule of this kind, *X* would be treated as an investment company because more than 50 percent of its total assets would consist of stocks and over 80 percent of its total assets would be held for investment purposes.

portfolio stocks or securities in the ordinary course of conducting its activities (such as buying or selling in response to trends in the stock market). This rule is intended, however, to affect situations where a major purpose of an asset acquisition is specifically to circumvent the limitations under this provision, so that a reorganization involving that corporation can subsequently occur and escape the tax treatment which this amendment would impose if the company's assets had not been manipulated. It is expected that specific rules for tax avoidance situations of this kind will be prescribed by the Internal Revenue Service.

Diversification test.—A company meeting the definition of an "investment company" is considered to have an undiversified portfolio unless (immediately before the reorganization) it is a regulated investment company as defined in section 851 of the Code, a real estate investment trust as defined in section 856 of the Code, or a company which satisfies both of the following rules: (a) it does not own any 5 or fewer stocks or securities whose combined value constitutes over 50 percent of the fair market value of all of the corporation's assets, and (b) no one stock or security constitutes over 25 percent of the total fair market value of all of its assets. In applying the tests, an investment company which fails either or both tests will be considered undiversified. Also, total assets will be determined by reference to the same rules (described above) which apply in determining whether a corporation is an investment company.[19] (Thus, for example, cash is ignored in determining whether one stock constitutes over 25 percent of the value of all of the company's assets).

The Act also delegates authority to the Service to disregard active business assets or other properties which an investment company deliberately acquires before a planned reorganization for the purpose of qualifying the company as diversified under the above tests.[20]

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[19] For purposes of this rule, stock or securities are to have the same meaning as they have in defining an investment company under this reorganization rule. In addition, the stock of all members of a controlled group of corporations (as defined in section 1563(a) of the Code) are to be treated as the stock of a single company.

A look-through rule similar to the rule used in defining an "investment company" also applies in determining whether an investment company is diversified. In the example set forth in footnote 18, *X* would be deemed to own $70,000 of *C's* assets directly. As such, *X* would be considered diversified because neither stock *A* nor stock *B* would be valued at over 25 percent of *X's* total assets ($155,000), and the combined value of the two portfolio stocks (*A* and *B*) would not be greater than half the value of all of *X's* total assets ($155,000). Without this look-through rule, the value of *X's* stock in *A* would exceed 25 percent of *X's* total assets ($30,000/$100,000) and the rule would treat *X* as undiversified.

[20] Assume, for example, that the only assets owned by Corporation *X* are appreciated stock in listed company *Y* worth $100,000 and appreciated real estate worth $75,000. In a deliberate attempt to satisfy the diversification test, *X* borrows $225,000 and purchases stock in nine other listed companies for $25,000 each. *X* would then satisfy the diversification test because no more than 25 percent of its total assets (i.e., no more than $100,000 of $400,000) would be invested in the stock of one issuer, and no combination of five or fewer stocks would amount to over 50 percent of the value of *X's* total assets (i.e., the combined value of no five or fewer stocks would exceed $200,000).

Under the delegation (sec. 368(a)(2)(F)(iv)), however, the stock in the nine corporations purchased by *X* to satisfy the diversification test is to be disregarded in determining whether *X* is diversified. As a result, *X* would not meet the diversification test because more than 25 percent of its total assets (i.e., $100,000 of total assets of $175,000, disregarding the stock in the nine corporations) would be invested in one issuer (company *Y*).

The intended scope of the authority delegated to the Service under the diversification test is identical to the scope of the authority delegated to the Service in determining whether a corporation is an investment company for purposes of this provision (see the earlier discussion of the latter delegation).

Other provisions.—The specific reorganizations to which the above rules will apply are the five exchanges listed in section 368(a)(1)(A), (B), (C), (D), and (F).[21]

An express exception is made to the denial of tax-free reorganization treatment for situations where the stock of two or more investment companies is owned substantially by the same persons in the same proportions. In these cases the shareholders and security holders of the companies being combined ordinarily will not diversify their stock investments after the transaction: the Act accordingly permits reorganizations of commonly controlled investment companies to continue tax-free. It is expected that the Service will set forth by regulation the detailed rules needed to carry out the purposes of this exception.[22]

Since denial of tax-free reorganization treatment adversely affects the acquired company (and its shareholders) but does not require recognition of gain or loss by the acquiring company (or its shareholders), a rule is added to cover what is, in effect, a "reverse acquisition." This rule (in new section 368(a)(2)(F)(vi)) is designed to assure that regardless whether an investment company is, in form, the acquired or acquiring party, tax-free reorganization treatment will be denied for the portion of the exchange involving an undiversified investment company (and its shareholders and security holders). If two or more undiversified investment companies combine with each other, gain should be recognized by both companies (and by their shareholders and security holders as appropriate) rather than solely by the company which is formally acquired by the other. Otherwise, an undiversified investment company which is the acquiring company will obtain tax-free diversification.

Therefore, the Act provides that an undiversified investment company (and its shareholders and security holders) which is the acquiring or surviving party is to be considered as having been acquired by the other party in an exchange which must itself be tested under section 368(a)(2)(F).

For example, if an undiversified investment company acquires the assets of a diversified investment company in a statutory merger or a "C" reorganization, the acquired company or its shareholders may continue to qualify for reorganization treatment (since that company is an already-diversified investment company). However, for purposes

[21] A recapitalization (sec. 368(a)(1)(E) is not included because a recapitalization involves only one corporation, and although various tax-free changes are permitted to be made in an existing shareholder's rights in the same corporation (such as changes in voting rights and changes from debt to equity interests), this does not produce the kind of diversification in investors' interests which resembles the tax-free formation of an exchange fund.

[22] It is anticipated that the Service will provide a rule that if common control over two or more corporations is obtained for the specific purpose of bringing a later reorganization under this exception, the exception will not be available. (A similar rule is contained in section 1.382(b)-1(d)(3) of the Income Tax Regulations.)

Several courts have held that a combination of two or more commonly owned operating corporations may qualify as an "F" reorganization (sec. 368(a)(1)(F)). The Service has accepted this treatment if several conditions are satisfied, including a complete identity of shareholders and their proprietary interests in the transferor and acquiring corporations (Rev. Rul. 75-561, 1975-2 C.B. 129). Congress does not intend the changes made by the Act to affect the question whether an "F" reorganization can occur where two or more corporations are combined or, if so, whether an "F" reorganization can occur if complete identity of ownership does not exist.

of determining recognition of gain or loss, the Act treats the acquiring company and its shareholders (and security holders) as having been acquired by the other company in a statutory merger or "C" reorganization. Since nonrecognition treatment will be denied on such a constructive exchange, the undiversified company would be treated as if it had exchanged its assets in a taxable exchange for stock of the diversified company and then had distributed that stock to its own shareholders and security holders in a taxable exchange for their stock in the undiversified company.

If two undiversified investment companies merge with each other, the general rule (new section 368(a)(2)(F)(i)) denies reorganization status to the acquired company and its shareholders. The special "reverse acquisition" rule will also test the company which is formally the acquiring company as though it and its shareholders had been the acquired parties. As a result, that company (and its shareholders) will be considered to have made an exchange and, since the exchange will be considered made with another undiversified investment company, the special rule will deny nonrecognition treatment to that constructive exchange (and treat that company as having made a taxable exchange).[23] Both companies in this example will be treated as having made a taxable exchange with each other.

Where the reverse acquisition rule requires recognition of gain or loss by an acquiring investment company or by its shareholders and security holders, collateral tax consequences of the exchange will be determined as though that company had made a taxable sale or exchange of its assets, and as though its shareholders and security holders had made a taxable exchange of their interests in their own company. For the effects on basis and on section 381 items, see footnote 13.

Under these rules, no change is made in the tax-free treatment available under present law where one or more regulated investment companies or real estate investment trusts merge (or otherwise reorganize) with each other. The Act will also not affect mergers solely involving active business companies which are not "investment companies" (as defined in the Act). Nor will the new rules prevent a tax-free merger solely of one undiversified investment company with an active business company (which is not an investment company after the merger).

[23] Where an undiversified investment company acquires the stock of another corporation in an exchange described in section 368(a)(1)(B), the shareholders of the acquiring company may be treated as having made a taxable exchange. The shareholders will be treated as having exchanged their stock for stock of the other corporation; that constructive exchange will then be tested under the general rule of new section 368(a)(2)(F). If, under that test, the constructive exchange does not qualify for nonrecognition treatment (because, for example, the other corporation is also an undiversified investment company), the shareholders of the undiversified company will be deemed to have received stock in the constructive exchange equal in value to the value of their stock in their own company. The intent of the second sentence of section 368(a)(2)(F)(vi) is that the shareholders of the undiversified investment company, in this situation, must recognize gain in the amount of the difference between the basis and fair market value of their stock in their own company determined immediately after the actual exchange.

For example, if undiversified investment company X, whose total fair market value is $1 million, acquires all of the stock (worth $2 million) of undiversified investment company Y, the shareholders of X must recognize gain equal to the excess of the $1 million value of their X stock over their basis in their X shares. If the acquisition had actually taken the reverse form, i.e., had corporation Y acquired all the stock of corporation X, the combined value of the two companies after the exchange would have been $3 million and X's former shareholders would have received a one-third stock interest in the acquiring company Y, which stock interest would have been worth $1 million. The amount of gain required to be recognized in this situation under the Act thus conforms to the amount of gain that would be recognized if the actual acquisition had been reversed and if nonrecognition treatment were denied to the exchange as reversed.

Effective date

These reorganization rules apply to exchanges consummated after February 17, 1976. The Act makes an exception for exchanges occurring after February 17, 1976, pursuant to a private tax ruling issued by the Internal Revenue Service before February 18, 1976. The tax ruling must have held that the proposed reorganization will qualify as a reorganization under sec. 368(a)(1) of present law.

Revenue effect

It is estimated that these provisions will increase budget receipts by less than $5 million annually.

32. Contributions of Certain Government Publications (sec. 2132 of the Act and sec. 1221 of the Code)

Prior law

In most situations, Government publications received by taxpayers without charge (e.g., copies of the Congressional Record received by Members of Congress) or at a reduced price were treated as capital assets under prior law. One consequence of that treatment was that taxpayers could claim a deduction for the full fair market value of any Government publication which they contributed to a charity (such as a library or a university) for a use related to the charity's exempt purpose.

Reasons for change

Congress felt that it was not appropriate for taxpayers to receive deductions for the full fair market value of Government publications they contributed to charity in situations where they received the Government publications free of charge or at a reduced price and were not required to include in income the value of the free publications or the bargain element in the case of publications purchased at a reduced price.

Explanation of provisions

Under the Act, U.S. Government publications which are received from the Government without charge or below the price at which they are sold to the general public are no longer to be treated as capital assets in the hands of the taxpayer receiving the publications. This treatment is also to apply to any Government publication held by a taxpayer in whose hands the basis of that publication is determined by reference to its basis in the hands of a person who received it free or at a reduced price.

Effective date

This provision applies to sales, exchanges, and contributions made after the date of enactment (October 4, 1976).

Revenue effect

This provision will result in a negligible revenue gain.

33. Study of Tax Incentives by Joint Committee (sec. 2133 of the Act)

Prior law

There was no specific requirement for a Congressional study of the impact of various tax incentives.

Reasons for change

The Congress often has incomplete background information as to what are the best tax incentives or what the effect of tax cuts on the economy is. The information provided by a staff study would enable the Congress to make sure that tax incentives, like other forms of Federal expenditures, would be as cost effective as possible.

Explanation of provision

The Act requires the Joint Committee on Taxation to study, in consultation with Treasury, tax incentives, especially as used to provide stimulus to the economy during a recession. A report is to be made to the Senate Finance Committee and the House Ways and Means Committee no later than September 30, 1977.

Effective date

This provision is effective upon enactment.

Revenue effect

This provision has no revenue effect.

34. Prepaid Legal Services (sec. 2134 of the Act and secs. 120 and 501(c)(20) of the Code)

Prior law

Prepaid group legal services plans are a recent, innovative means of providing legal services. Because of the relative novelty of these fringe benefit plans and the variety of their design, the tax treatment of the employer contriputions on behalf of the employee and the tax treatment of the benefits received by the employee under such plans had not been clearly established.

However, depending on the structure of the plan, it appears that under prior law the employee was required to include in his income either (1) his share of the amounts contributed by his employer to the group legal services plan or (2) the value of legal services or reimbursement of expenses for legal services received under the employer-funded plan, or both. (If plans were funded with contributions which were partially taxable and partially tax-free to the employee, the employee might have been required to include any benefits in income to the extent the contributions for the plan constituted amounts not previously included in the employee's income.)

However, amounts contributed by the employer for an employee to a group legal services plan or the value of services or reimbursements if provided directly by the employer to the employee under a plan are deductible by the employer as ordinary and necessary business expenses, if they meet the usual standards for trade or business deductions.

Reasons for change

The Congress believed that it was appropriate to provide a tax incentive to promote prepaid legal services plans. Within the last 3 years, the American Bar Association and many State bar associations have endorsed the creation of this type of arrangement as a means of making legal services more generally available. Several unions have already established prepaid group legal services plans which are supported entirely or in part by employer contributions.

The Congress believed that excluding such employer contributions from the employees' income would promote interest in such plans and increase the access to legal services for many taxpayers by encouraging employers to offer and employees to seek such plans as a fringe benefit.

The Congress decided a tax incentive, which would increase the availability of legal services, would be especially helpful to middle-income taxpayers who at present may be the most under-represented economic group in terms of legal services. Lower-income persons have access to publicly-supported legal aid services, while taxpayers with higher incomes can generally afford their own legal expenses.

The Congress believed that providing favorable tax treatment for group prepaid legal services plans (which has some similarity to the tax treatment provided for accident and health plans) would grant taxpayers some relief from the high cost of legal fees and would promote the adoption and implementation of such plans by many employers and employees.

In order to insure that the tax law encourages only those plans which may be considered nondiscriminatory employee fringe benefits, the Congress decided that it was necessary to adopt rules which would prohibit discrimination and minimize the possibility of abuse of the tax incentive by those taxpayers who might create such plans to channel otherwise taxable compensation through a plan providing a tax-free fringe benefit.

Explanation of provision

The Act excludes from an employee's income amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses or dependents) as well as any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for legal services for the employee, his spouse, or his dependents. The exclusion does not apply to direct reimbursements made by the employer to the employee.

In order to be a qualified plan under which employees are entitled to the tax-free benefits provided by the Act, a group legal services plan must fulfill several requirements with regard to its provisions, the employer, and the covered employees. In determining whether the statutory requirements are fulfilled, the "plan" which is to fulfill such requirements is the prepaid legal services arrangement agreed upon by the employer and his employees. The requirements are designed to insure that the tax-free fringe benefits are provided on a nondiscriminatory basis and that the possibility of tax abuse through the misuse of such plans is minimized.

A qualified group legal services plan must be a separate written plan of an employer for the exclusive benefit of his employees or their spouses or dependents. The plan must supply the employees, their spouses, and dependents with specified benefits consisting of personal (i.e., nonbusiness) legal services through prepayment of, or provision in advance for, all or part of an employee's, his spouse's, or his dependents' legal fees. Benefits must be set forth so that the employees understand what legal services are covered by the plan.

The Act also provides that amounts contributed by employers under a plan may be paid only (1) to insurance companies or to organizations or persons that provide personal legal services or indemnification against the cost of personal legal services, in exchange for a prepayment or a payment of a premium; (2) to organizations or trusts exempt under new section 501(c)(20), described below; (3) to organizations described in section 501(c) which are permitted to receive employer contributions for one or more qualified group legal services plans, provided the organizations pay or credit the employer contributions to another organization or trust which is exempt under section 501(c)(20); (4) as prepayments to providers of legal services under the plan, or (5) to a combination of the four permissible types of payment arrangements.

In order to be a qualified plan, a group legal services plan must also meet requirements with respect to nondiscrimination in contributions or benefits and in eligibility for enrollment. The Act requires that the contributions paid by an employer and the benefits provided under a plan may not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly-compensated. The plan must benefit employees who qualify under a classification which the employer sets up and which the Service determines does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly-compensated. However, in determining whether the classification is discriminatory the employer may exclude from the calculations those employees who are members of a collective bargaining unit if there is evidence that group legal services plan benefits were the subject of good faith bargaining between representatives of that group and the employer.

A limit is placed on the proportion of the amounts contributed under the plan which can be for employees who own more than 5 percent of the stock or of the capital or profits interest in the employer corporation or unincorporated trade or business. The aggregate of the contributions for those employees and their spouses and dependents must not be more than 25 percent of the total contributions.

Under the Act, in order to be treated as a qualified group legal services plan, the plan must notify the Internal Revenue Service that it is applying for recognition of this qualified status. If the plan fails to notify the Service by the time prescribed in Treasury regulations, then the plan cannot be regarded as a qualified plan for any period before it in fact gave notice. For example, if the Treasury regulations provide that a plan is required to notify the Service before the end of the first plan year in order to be treated as a qualified plan from the beginning of the first plan year, and the organization does not file its notice until half-way through the second plan year, then (1) the organization is not qualified for its first plan year, and (2) the organization is not qualified for that part of the second plan year preceding the date on which the notice finally was filed. However, if the notice was filed on the last day of the first plan year, then the organization would be qualified from the first day of that first plan year.[1]

[1] Recognizing that existing plans are to be covered by this provision and that there may be a delay in the final publication of these notification regulations, the Act also provides that this initial notice is to be considered timely if it is given at any time through the 90th day after the publication of the first final Treasury Regulations on this point.

Furthermore, several additional special rules and definitions apply to qualified group legal services plans.

An individual who qualifies as an employee within the definition in section 401(c)(1) of the Code is also an employee for purposes of these group legal services provisions. This means that, in general, the term "self-employed individual" means, and the term "employee" includes, individuals who have earned income for a taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for a taxable year.

An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer. A partnership is considered the employer of each partner who is also an employee of the partnership. Under a special rule for the allocation of contributions, the Treasury Department's regulations must provide that allocations of amounts contributed under the plan shall take into account the expected relative utilization of benefits to be provided under the plan from those contributions or plan assets and the manner in which any premium charge (or retainer or other price) for the plan was developed.

The term "dependent" has the meaning given to it under section 152. Therefore, the plan may cover an individual whose relationship to the employee is listed in section 152, if the employee provides over half of the support for that individual for the calendar year in which the employee's taxable year begins. Since the plan must be for the exclusive benefit of employees and their spouses and dependents, the plan may not cover any other persons.

For determining stock ownership in corporations, the Act adopts the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). The Treasury Department is to issue regulations for determining ownership interests in unincorporated trades or businesses, such as partnerships or proprietorships, following the principles governing the attribution of stock ownership.

The Act also provides that an organization or trust created or organized in the United States, whose exclusive function is to form part of a qualified group legal services plan under section 120, is to be exempt from income tax (new sec. 501(c)(20)). Such a trust shall be subject to the rules governing organizations exempt under section 501(c), including the taxation of any unrelated business income, an exempt organization or trust which receives employer contributions for a group legal services plan because of section 120(c)(5)(C) will not be prevented from qualifying for exemption under section 501(c)(20) merely because it provides legal services or indemnification for legal services unassociated with a qualified group legal services plan.

The Act also requires a study to be done by the Departments of the Treasury and of Labor, about the desirability and feasibility of continuing the benefits provided by this provision, with final reports to be submitted to the President and the Congress not later than December 31, 1980.

Effective date

This provision applies prospectively for five taxable years beginning after December 31, 1976, and ending before January 1, 1982.

The time within which a plan must apply to the Internal Revenue Service for recognition of its status as a qualified group legal services plan under the notice requirement of the Act does not expire before the 90th day after the Treasury Department's regulations on this point first become final.

A written group legal services plan that was in existence on June 4, 1976, is to be treated as meeting the requirements for a qualified plan up to the 180th day after the date of enactment. If, on June 4, 1976, the plan was maintained under a collective bargaining agreement, then the plan is to continue to be treated as qualifying under the Act until the 180th day after enactment or either until the date on which the last of the collective bargaining agreement under which the plan is maintained terminates or December 31, 1981, whichever is earlier (determined without regard to any extension of the agreements after October 4, 1976, i.e., the date of enactment of the Act.) After the applicable date, the plan must comply with the antidiscrimination, etc., requirements set forth in this provision (new sec. 120) in order for the tax benefits provided by the Act to apply.

Revenue effect

It is estimated that this provision will decrease budget receipts by $5 million for fiscal year 1977, $8 million for fiscal year 1978, and $33 million for fiscal year 1981.

35. Certain Charitable Contributions of Inventory (sec. 2135 of the Act and sec. 170 of the Code)

Prior law

Under prior law (sec. 170(e)), a taxpayer who made a charitable contribution of property was required to reduce the amount of the deduction (from fair market value) by the amount of ordinary gain he would have realized had the property been sold instead of donated to charity. (Under certain circumstances, a taxpayer was also required to reduce the amount of his charitable contribution by a portion of the capital gain he would have received if the property had been sold.) Thus, the donor of appreciated ordinary income property (property the sale of which would not give rise to long-term capital gain) could deduct only his basis in the property rather than its full fair market value.

When this rule was added to the Code in 1969, it was intended, in part, to prevent the abuse situations in which taxpayers in high marginal tax brackets and corporations could donate to charity substantially appreciated ordinary income property and actually be better off, after tax, than they would have been if they had sold the properties and retained all the after-tax proceeds of the sales.

Reasons for change

The rule that the donor of appreciated ordinary income property could deduct only his basis in the property effectively eliminated the abuses which led to its enactment; however, at the same time, it has resulted in reduced contributions of certain types of property to charitable institutions. In particular, those charitable organizations that provide food, clothing, medical equipment, and supplies, etc., to the needy and disaster victims have found that contributions of such items to those organizations were reduced.

Congress believed that it was desirable to provide a greater tax incentive than in prior law for contributions of certain types of ordinary income property which the donee charity uses in the performance of its exempt purposes. However, Congress believed that the deduction allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

Explanation of provision

The Act allows a corporation (other than a subchapter S corporation) a deduction for up to half of the appreciation on certain types of ordinary income property contributed to a public charity (other than a governmental unit) or a private operating foundation.

In order to qualify for this treatment, the following conditions must be satisfied: (1) the donee must use the property in a use related to its exempt purpose and solely for the care of the ill, the needy, or infants; (2) the donee must not transfer the property in exchange for money, other property, or services; (3) the donor must receive a statement from the donee representing that its use and disposition of the property will comply with requirements (1) and (2) above; and (4) the property must satisfy the relevant requirements of the Federal Food, Drug, and Cosmetic Act in effect on the date of transfer and for 180 days prior to such transfer.

If all these conditions are complied with, the charitable deduction is generally for the sum of (1) the taxpayer's basis in the property and (2) one-half of the unrealized appreciation. However, in no event is a deduction to be allowed for an amount which exceeds twice the basis of the property. Furthermore, no deduction is to be allowed for any part of the unrealized appreciation which would have been ordinary income (if the property had been sold) because of the application of the recapture provisions relating to depreciation, certain mining exploration expenditures, certain excess farm losses, certain soil and water conservation expenditures, and certain land-clearing expenditures.

Effective date

This provision applies to charitable contributions made after October 4, 1976.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of $19 million in fiscal year 1977, $22 million in fiscal year 1978, and $24 million in fiscal year 1981.

36. Tax Treatment of Grantor of Certain Options (sec. 2136 of the Act and sec. 1234 of the Code)

Prior law

The tax treatment of puts and calls under prior law was based largely on several widely publicized private letter rulings issued to the Chicago Board of Options Exchange (CBOE) in which the Internal Revenue Service interpreted the application of Internal Revenue Code sections 1233 (relating to short sales) and 1234 (relating generally to options to buy or sell), the regulations under those sections and previously published revenue rulings to option transactions. The rulings assume that options are capital assets in the hands of their holders, and that the securities which would underlie or would be acquired in connection with options are also capital assets in the hands of the holders or writers (sec. 1234(a)).

One aspect of the private rulings, the tax treatment of closing transactions, has significant tax planning potential. In a closing transaction, the writer (seller) of an option cancels his obligation under that option by purchasing from the exchange an option with terms identical to the option he had previously written. Under the Service's ruling, the difference between the amount paid in the closing transaction and the premium originally received by the option writer is ordinary income or loss.

The Service has also ruled that premium income from the lapse of an option is ordinary income to the option writer (see reg. § 1.1234–1(b)).

Reasons for change

Since the decision of whether or not to enter a closing transaction is usually within the discretion of the taxpayer, the revenue ruling described above has resulted in an opportunity for some taxpayers to plan tax strategies (described in more detail below) under which they realize ordinary loss on one part of a transaction, while realizing long or short term capital gain on another related transaction involving the same stock or securities.

Assume, for example, that a taxpayer in the 50 percent tax bracket purchases 100 shares of IBM for $200 a share; he also writes a call on the stock at a striking price of $200 per share, for a premium of $2,500. If the value of the stock rises to $250 per share, and the taxpayer has held his stock for more than 6 months, he may sell the stock, realizing a long-term capital gain of $5,000 on which he owes $1,250 tax. He also enters a closing transaction with repsect to his call by purchasing a call on IBM at a striking price of $200 per share; he would pay a premium of about $5,000 under these circumstances, and the resulting loss of $2,500 (determined by subtracting the premium the taxpayer received for the call he wrote from the premium he paid for the call he purchased) would be ordinary loss which could be offset against ordinary income for a tax saving of $1,250. The net result is that the taxpayer pays no tax on transactions producing a net economic income of $2,500.

To prevent this situation from occurring in the future, the Act, in effect, reverses the private ruling with respect to closing transactions by providing that gain or loss from a closing transaction is to be treated as short-term capital gain or loss.[1]

Explanation of provisions

The Act provides that gain or loss from a closing transaction would be taxed as short-term capital gain or loss rather than as ordinary income. The effect of this change would eliminate the feature of existing law which permits conversion of ordinary income into capital gain.

Under the Act, any loss on a closing transaction would be treated as a short-term capital loss which would have to be netted against the

[1] This provision is virtually identical with H.R. 12224. The Ways and Means Committee Report on that provision is House Report 94–1192. For a further discussion of reasons for change in this area, see that report at pages 5–8.

taxpayer's capital gains.[2] Thus, in the example described above, the $2,500 short-term capital loss would be subtracted from the $5,000 long-term capital gain, leaving a net long-term capital gain of $2,500. A taxpayer in the 50-percent bracket would pay a tax of $625 on this amount.

Options covered under the rules of the Act include options (and privileges) in stock and securities (including stock and securities dealt with on a "when issued" basis) and options in commodities and commodity futures.

Treatment of income from lapsed options.—Under the ruling issued to the CBOE, premium income from a lapsed option is treated as ordinary income to the option writer. In some cases this rule can result in a serious hardship for some investors.

Under the tax law, a person who has substantial capital losses may not offset those losses (except to a very limited extent) against premium income, even if the capital losses result from transactions in stock underlying covered options. Thus, for example, assume that X purchases 1,000 shares of IBM at $200 per share and writes a call on the stock at that price, receiving a premium of $10,000. If the stock declines to 190, the call will lapse (because it is worthless) and, under present law, X will have ordinary income of $10,000. If he sells the IBM stock, he will also have a $10,000 capital loss but, under prior law, only $1,000 of this amount could be offset against the income from writing the call.

The Act deals with this problem by providing that income from a lapsed option is to be treated as short term capital gain. Thus, in the example set forth above, the $10,000 gain from writing the option could be offset against the $10,000 capital loss which the taxpayer experienced with respect to the sale of the stock.

Treatment of broker-dealers.—Under the Act, the rules just outlined with respect to closing transactions and option lapse income are not to apply in the case of options written by the taxpayer in the ordinary course of his trade or business. Gain or loss from transactions in options written in the ordinary course of the taxpayer's trade or business would continue to be treated as ordinary income or loss. This rule is consistent with the provisions of the tax law generally concerning the tax treatment of broker-dealers in stock or securities. It is possible, of course, that some taxpayers may write certain options in the ordinary course of their trade or business, and may write other options in connection with their investment activities. In such cases, the new rules would apply to options written in connection with the taxpayer's investment activities. The determination as to whether an option is written in the ordinary course of a taxpayer's trade or business, or as an investment, is to be determined under principles similar to those which apply the tax law in the case of a broker-dealer in securities. Generally, it is anticipated that persons who are treated as writers of options in the ordinary course of their trade or business will be those who "make a market" with respect to a particular option.

[2] Under the tax law, a taxpayer's short-term capital losses are netted against his short-term capital gains, if any. The net short-term capital loss is then netted against his long-term capital gains. The remaining net loss, if any, may then be deducted against ordinary income to the extent of $1,000 per year, but under section 1401 of the Act, this is increased to $2,000 for taxable years beginning in 1977 and to $3,000 for years beginning after 1977.

Trading in options by regulated investment companies.—Under the tax law, regulated investment companies are treated in many respects as a conduit to their shareholders; that is, the mutual fund itself is not subject to tax on income which it distributes to shareholders. Instead, the shareholders are taxed, and the income received by the shareholders generally has the same character in their hands (long or short term capital gain, dividends, interest, etc.) as it would have had if the shareholders had made the underlying portfolio investments directly, rather than through the mutual fund. The purpose of these rules is to give the average investor an opportunity to participate in a diversified portfolio.

However, regulated investment companies are also subject to a number of rules and restrictions with respect to their operations. Among these rules is a requirement that at least 90 percent of gross income must be derived from dividends, interest, and gains from the sale of "stock or securities" (sec. 851(b)(2) of the Code). The purpose of these and other requirements is to help ensure that the regulated investment company is essentially engaging in passive investment activities, and is not operating as a normal business corporation.

The Service has ruled in Rev. Rul. 63–183, 1963–2 C.B. 285, that amounts derived by a regulated investment company from writing put and call options which lapse do not constitute gains from the sale or other disposition of stock or securities within the meaning of section 851(b)(2).[3] Accordingly, a corporation under prior law would not qualify as a regulated investment company if more than 10 percent of its gross income consisted of premiums from the writing of puts and calls which lapse.

Under the provisions of the Act, options are to be treated as capital transactions. Options are often written in connection with a taxpayer's transactions in stock or securities underlying the options and can, in many cases, be a means of protecting a taxpayer's gains or minimizing his risks in the securities market. Moreover, income from the writing of options would appear to be the kind of passive investment income which a regulated investment company is intended to receive.

Thus, there would appear to be no reason why income from the lapse of a covered or uncovered put or call should not be treated as qualifying income for purposes of the income source test which regulated investment companies are required to meet under section 851(b)(2) of the Code. Accordingly, the Congress intends that such income is to be treated as income from the sale or other disposition of a stock or security within the meaning of that test. In addition, it is intended that income from a closing transaction in options, as well as income from the lapse of an option, is to be treated as qualifying income.

Also, under section 851(b)(3) of the Code, less than 30 percent of the gross income of a regulated investment company can be derived from the sale or other disposition of stock or securities held for less than 3 months. The Congress intends that for purposes of this rule, the holding period of the option which the regulated investment company writes is to be treated as commencing on the date when the option

[3] If a call is exercised, the premium would be treated as income received by the mutual fund on the underlying stock.

is written. For purposes of section 851(b)(4), the "issuer" of an option is the corporation whose stock or securities underlie the option (even though the option may be written by an options exchange, for example.).

Also, under the tax law, exempt organizations are generally subject to tax only on their "unrelated business income." In the case of most exempt organizations, capital gains are excluded from the unrelated business income tax. Since income from the lapse of options and from closing transactions was treated as ordinary income under prior law, this income was not excluded from the unrelated business income tax base. Under the Act, these items of income would be treated as short term capital gains, and therefore income from the lapse of a covered or uncovered option, or from a closing transaction in a covered or uncovered option, would not be treated as unrelated business income.[4]

Tax Treatment of Foreign Option Writers.—The tax law provides, in general, that interest, dividends and other similar types of income of a nonresident alien or a foreign corporation are subject to a 30-percent tax on the gross amount paid if the income or gains are not effectively connected with the conduct of a trade or business within the United States (secs. 871(a) and 881). This tax is generally collected through withholding by the person making the dividend, interest or other payment to the foreign recipient of the income (secs. 1441 and 1442).

Nonresident alien individuals are only subject to tax on their non-effectively connected capital gains if they are present in the United States for 183 days or more during the taxable year. Those capital gains which are subject to tax (because of the 183 day rule) are subject to a 30-percent tax on the net amount of the gains and losses for the year. Also, corporations are not subject to tax on their noneffectively connected capital gains. Any income or gain of a foreign person which is effectively connected with the conduct of a trade or business within the United States is subject to the regular individual or corporate tax rates as the case may be (sec. 871 or 881 or 882). However, the trading in stocks or securities by a foreign investor for his own account is not to be deemed engaging in a trade or business within the United States.

The rules under prior law dealing with the tax treatment of income derived by a foreign person from the writing of an option were not clear in all situations. For example, if a call option written by a foreign investor is exercised, then the premium is considered as part of any gain realized by the foreign investor from the sale of the underlying stock and the investor is only subject to U.S. tax on the gain if he is present in the United States for 183 days or more, or if the gain was effectively connected with the conduct of a trade or business within the United States. In no case is a 30-percent withholding tax on the gross amount of the premium from writing the option imposed. A tax would either be imposed at a 30-percent rate on the net amount of gain for the entire year (by reason of the 183 day rule), or at the

[4] Those interested in this area should also be aware of Public Law 94–396, which amends section 512(b)(5) of the Code to provide that income from the lapse of an option or from a closing transaction is not to be treated as unrelated business income. That Act applies to options which lapse, or which are the subject of a closing transaction, which occurs on or after January 1, 1976.

applicable individual or corporate rates (in the event of effectively connected capital gains). On the other hand, the tax treatment under prior law with respect to gain or loss realized on the lapse of an option or in a closing transaction is unclear. Some concluded that the premium was subject to the 30-percent tax on the gross amount while others concluded that the premium was not subject to this tax.

Under the Act, since option lapse income and income or loss from closing transactions is to be treated as short term capital gain or loss, the result is that gain from the lapse of an option or from a closing transaction is exempt from U.S. tax in most instances. The Congress believes that this is a sound result since it is not administratively feasible to impose a 30-percent withholding tax on the amount of the premium because when the premium is paid it is not known whether the option will be exercised, will be allowed to lapse, or will be subject to a closing transaction.[5]

The Congress understands that a question exists under the tax law as to whether a corporation realizes income when warrants to purchase the corporation's stock expire unexercised. This issue was not considered by the Congress in connection with this revision, and no inference is intended (for the past or for the future) with respect to whether the expiration of warrants issued by a corporation for its own stock should, or should not, result in recognition of taxable income to the corporation.

Effective date.—The amendments made by the act are to apply to options granted after September 1, 1976.

Revenue effect

It is estimated that this revision will result in a revenue gain of $3 million in fiscal year 1977, and $10 million per year thereafter.

37. Exempt-Interest Dividends of Regulated Investment Companies (sec. 2137 of the Act and secs. 265 and 852 of the Code)

Prior law

Generally, distributions by a regulated investment company (commonly called a mutual fund) from capital gains recognized by it may be treated as capital gain to its shareholders (i.e., the character of the capital gain is "flowed-through" to the shareholders). Under certain conditions, similar flow-through treatment is provided for dividend income. However, there is presently no flow-through treatment for tax-exempt interest and, consequently, distributions of tax-exempt interest by a regulated investment company are taxable income to its shareholders.

Reasons for change

Congress believes that small investors should be permitted to invest in tax-exempt securities and still obtain the advantages of diversification and expert management available through the use of regulated investment companies. In order to achieve these aims, Congress believes that the character of tax-exempt interest from certain governmental obligations should be "flowed-through" to shareholders of

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[5] Also, it is the Congress' intention that trading in options is to be treated in the same way as trading in the underlying stock, securities, or commodities for purposes of section 864(b)(2) of the code.

regulated investment companies that invest most of their funds in these kinds of assets.

Explanation of provision

The Act amends the provisions of the Code dealing with regulated investment companies to permit, under certain circumstances, the shareholders of those companies to treat dividends paid by the company from tax-exempt interest as if the shareholders had received the tax-exempt interest directly themselves. In order to qualify for this treatment, a regulated investment company must invest at least 50 percent of the value of its assets in tax-exempt securities. In addition, the regulated investment company must distribute at least 90 percent of both its investment company taxable income and its net income from tax-exempt securities.

The amount of tax-exempt income qualifying for the "flow through" treatment is the amount of tax-exempt interest received by the regulated investment company less an allocable portion of the administrative and other expenses that are attributable to the tax-exempt interest. An amendment is made to section 265 of the Code to provide that this allocable portion is determined by multiplying the administrative and other expenses by the ratio that the tax-exempt interest is to the sum of the gross income of the company (excluding capital gains net income) and the tax-exempt interest.

Qualifying dividends paid by a regulated investment company out of its tax-exempt interest will be treated by the company's shareholders as interest income from tax-exempt securities for all purposes. Consequently, such dividends do not constitute an item of gross income in the hands of the shareholder. An amendment is made to section 265 to make it clear that interest on indebtedness incurred or continued to purchase or carry shares of stock in a regulated investment company that pays qualifying dividends is not deductible. Where a regulated investment company pays dividends from both taxable and tax-exempt income, it is expected that the Treasury Department will issue regulations providing that an allocable portion of interest on indebtedness incurred or continued to purchase or carry shares in that company is not deductible.

Effective date

The new rules apply to taxable years beginning after December 31, 1975.

Revenue Effect

It is expected that the new rules will have no effect on revenues.

38. Common Trust Fund Treatment of Certain Custodial Accounts (sec. 2138 of the Act and sec. 584 of the Code)

Present law

Banks may generally hold in a common trust fund assets held by the bank in its capacity as trustee, executor, administrator or guardian. However, under prior law, common trust fund treatment did not apply to custodian accounts.

Reasons for change

Most States have a Uniform Gift to Minors Act which provides a convenient way to make gifts to minor children with the property taken out of the custody of the parent and administered by the bank or some other independent trustee. The concern had been expressed to Congress that gifts through these accounts were being discouraged because under prior law they did not qualify for common trust fund treatment.

Explanation of provision

The Act extends common trust fund treatment to custodial accounts The acts defines custodial accounts as those which the Secretary determines are established under a State law substantially similar to the Uniform Gifts to Minors Act (as published by the American Law Institute) and for which it is established to the satisfaction of the Secretary by the bank that the bank has responsibilities similar to that of a trustee or guardian.

Effective date

The provision is effective as of October 3, 1976.

Revenue effect

This amendment will have no revenue effect.

39. Support Test for Dependent Children of Separated or Divorced Parents (sec. 2139 of the Act and sec. 152(e) of the Code)

Prior law

Under prior law, the noncustodial parent received an exemption for a child (of separated or divorced parents) if (1) he or she contributed at least $1,200 for support of all the children of the separated or divorced couple, and (2) the custodial parent did not clearly establish the payment of more support for the child than the noncustodial parent. Otherwise, the custodial parent received the exemption.

Reasons for change

At present, the noncustodial parent gets the exemption for all of the children, no matter how many there are, if that parent contributes $1,200 for their collective support. The only thing that will keep that parent from getting, say, four exemptions for four children by simply contributing $1,200 is for the custodial parent to come in and clearly establish a greater contribution.

In these inflationary times, the Congress believes the noncustodial parent should not automatically get such an exemption for all the children. It should be $1,200 for each child before the custodial parent has the burden of such proof.

Explanation of provision

The Act allows the noncustodial parent to receive an exemption for a child only if he or she contributes at least $1,200 for *each* of the children in cases where the custodial parent cannot clearly establish the payment of greater support.

Effective date

The provision is effective for taxable years beginning after the date of enactment (after October 4, 1976).

Revenue effect

This provision has no effect on revenues, because it merely shifts the exemption from one taxpayer to another.

40. Deferral of Gain on Involuntary Conversion of Real Property (sec. 2140 of the Act and sec. 1033(g) of the Code)

Prior law

A taxpayer can elect to defer any gain realized on the involuntary conversion of real property held for productive use in a trade or business (and not stock in trade or other property held primarily for sale) if the converted property is replaced by property of a like kind. However, under prior law, the converted property must have been replaced no later than two years after the close of the first taxable year in which any of the gain was realized.

Reasons for change

If through condemnation proceedings property is taken for public projects, such as a road or irrigation project, under prior law, the owner was allowed 2 years in which to buy other similar property, in order to avoid a capital gains tax.

The Congress believes that a farm, for example, which has been condemned for a project, is very difficult to replace within a 2-year period.

This amendment gives a farmer or other property owner one more year, or 3 years, instead of 2 years, to acquire the exchanged property.

Explanation of provision

The Act extends the period for replacement to three years after the close of the first taxable year in which any of the gain from the conversion is realized.

Effective date

The provision applies to dispositions of property after 1974 unless condemnation proceedings began prior to the date of enactment. That is, if property was disposed of under the threat or imminence of condemnation after 1974, and no condemnation proceeding was filed in a court or with the appropriate administrative agency prior to enactment (October 4, 1976), the seller has three years to replace it with like property.

Revenue effect

This provision is expected to have a negligible effect on revenues.

41. Livestock Sold on Account of Drought (sec. 2141 of the Act and sec. 451(e) of the Code)

Prior law

A cash method taxpayer must include income from a sale or exchange in the taxable year of the sale or exchange.

Reasons for change

The Congress is concerned that as a result of severe drought conditions, many livestock producers have been forced to speed up the sale of their stock—often at sacrifice prices. In a great many instances, they are even selling their foundation herds.

The sale of foundation herds which can subsequently be replaced poses no particular tax problem. Prior law gave those dairymen and beef producers a 2-year period in which to carry out the replacement. However, for the sale of cattle which are not to be replaced as part of the foundation herd, the forced sale aspect posed a serious problem. In effect, the rancher is being forced to sell not only this year's cattle but next year's as well. Consider, for example, the situation of a livestock producer who might normally sell 400 to 500 yearling cattle in a marketing year. This same farmer from his foundation herds produces a number of young calves who normally would be pastured all during the current tax year and sold in the coming tax year. Due to a lack of feed he is forced to make an involuntary conversion this year of the young calves now selling for about $100 a piece. A typical example is a farmer making his normal sales of 400 to 500 yearlings and another 200 small calves giving him additional $20,000 of income in the current year which would normally be deferred until next year.

Similar problems arise with farmers who keep calves over as yearlings and then feed them out as fat cattle and sell them in the third year. The Congress has learned that in 1976 many of them were forced to sell the fat cattle, the yearlings, and also the calves giving them effectively 3 years of income in the tax year.

The Congress has previously dealt with a similar problem under section 451(d) relating to crop insurance payments.

Explanation of provision

Under the Act, a cash method taxpayer may elect to include in the taxable year following the taxable year of sale or exchange income from the sale or exchange of livestock sold on account of drought. This treatment is limited to income from the sale or exchange of livestock (1) the number of which is in excess of usual business practice, and (2) which would not have been sold but for the drought. Also, the drought must occur in an area which is designated as eligible for Federal assistance. The election is available only to a taxpayer whose principal trade or business is farming.

Effective date

The election is effective for taxable years beginning after December 31, 1975.

Revenue effect

This provision is expected to result in a revenue loss of $20 million in fiscal 1977 and a revenue gain of $20 million in fiscal 1978.

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