

DESCRIPTION OF TAX BILLS
(S. 388, S. 446, S. 464, S. 476, S. 499, S. 500, and S. 501)
SCHEDULED FOR A HEARING
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
ON MARCH 30, 1981

PREPARED FOR THE USE OF THE
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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on March 30, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are seven bills scheduled for the hearing: S. 388 and S. 446 (relating to tax treatment of investment and wraparound annuities), S. 464 (relating to modifications of private foundation rules), S. 476 (relating to special distribution rule for private foundations constituting bank holding companies), S. 500 (relating to inflation adjustment of income payout requirement for private foundations), S. 501 (relating to repeal of alternative income payout requirement for private foundations), and S. 499 (relating to rollover of gain on FCC-ordered disposition of broadcast property).

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

I. SUMMARY

1. S. 388—Senators Hatch and Tower
and
2. S. 446—Senators Symms and Lugar

Tax Treatment of Investment and Wraparound Annuities

Under rulings issued by the Internal Revenue Service in 1977 and 1980, earnings on assets invested in certain investment annuity contracts and “wraparound” annuity contracts are taxed currently to the individual owning the contract.

Under the bills, which are substantially identical in effect, tax would be deferred until benefits are paid under the contracts. Thus, investment annuities and wraparound annuities would receive the same tax treatment accorded traditional commercial annuities under present law (Code sec. 72(a)). The provisions of the bills would apply upon enactment.

3. S. 464—Senators Durenberger Moynihan, Baucus, Riegle, and Thurmond

Modifications of Private Foundation Rules

Payout rules

Under present law (Code sec. 4942), a private foundation is required to distribute for charitable purposes the greater of its minimum investment return (five percent of the fair market value of its investment assets) or its net income. The bill would repeal the alternative requirement under the foundation payout rule that, under present law, requires a private foundation to distribute any excess of net income over its minimum investment return.

The general distribution requirements are not applicable to private operating foundations. Under present law, to qualify as a “private operating foundation,” an organization must expend directly in the active conduct of its exempt activities substantially all (85 percent) of its net income (and must meet one of three alternative tests). Under the provisions of the bill, a foundation would be classified as a private operating foundation if it expends directly in the active conduct of its exempt activities an amount equal to the lesser of substantially all its net income or substantially all its minimum investment return (and meets one of the three alternative tests of present law).

The changes made by the bill in the payout rules would be effective for taxable years beginning after December 31, 1980.

Expenditure responsibility

Under present law, a private foundation is required to exercise "expenditure responsibility" over all grants to organizations other than public charities (Code sec. 4945). The Treasury regulations and Internal Revenue Service rules provide guidelines specifying the circumstances under which a donor foundation can rely on the Service's classification of a grantee organization as a public charity in determining that expenditure responsibility need not be exercised over grants to such organizations.

The bill would provide that a private foundation is not required to exercise expenditure responsibility over a grant to an organization if the aggregate amount of grants made during the year by the foundation (and by related foundations) to that organization does not exceed \$10,000. Also, the bill would provide that a grant to an organization which the Internal Revenue Service has determined to be a public charity is not subject to the expenditure responsibility rules, even though the donee organization loses its public charity status, unless (1) the grant was made after the date of publication by the Service that the donee organization has lost its qualified status, (2) the grant was made after the date on which the foundation acquires actual knowledge that the donee organization has lost its qualified status, or (3) the donor foundation has actual knowledge that the grant will cause the donee organization to lose its qualified status.

The amendments made by the bill to the expenditure responsibility rules would be effective for grants made after December 31, 1980.

Definition of family member

Present law contains a number of restrictions imposed on private foundations (such as prohibitions on self-dealing and excess business holdings) which depend on determinations of "disqualified persons." The term "disqualified person" includes a substantial contributor, a foundation manager, or a member of the family of either a substantial contributor or foundation manager. For this purpose, a member of the family includes all lineal descendants of the substantial contributor or foundation manager (Code sec. 4946).

The bill would limit the definition of family member to exclude lineal descendants more than two generations from the substantial contributor or foundation manager. Thus, lineal descendants other than children and grandchildren would not be treated as family members. This provision of the bill would be effective on January 1, 1981.

4. S. 476—Senators Durenberger and Boschwitz

Special Distribution Rule for Private Foundations Constituting Bank Holding Companies

Under present law (Code sec. 4942), a private foundation is required to distribute for charitable purposes the greater of its minimum investment return (five percent of the fair market value of its investment assets) or its net income.

The bill would provide a special valuation rule for purposes of computing the minimum investment return with respect to securities of banks, bank-related companies, and a bank holding company where the private foundation is a bank holding company. The value of such

securities would be determined by capitalizing the actual dividends received at a six percent capitalization rate.

The intended beneficiary of the bill would be the Otto Bremer Foundation of St. Paul, Minnesota. The provisions of the bill would apply to taxable years beginning after December 31, 1971.

5. S. 500—Senator Moynihan

Inflation Adjustment of Income Payout Requirement for Private Foundations

Under present law (Code sec. 4942), a private foundation is required to distribute for charitable purposes the greater of its minimum investment return (five percent of the fair market value of its investment assets) or its net income.

The bill would adjust the amount of the foundation's income to account for inflation, so that a private foundation would be required to distribute the greater of its minimum investment return or its inflation-adjusted income. The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

6. S. 501—Senator Moynihan

Repeal of Alternative Income Payout Requirement for Private Foundations

Under present law (Code sec. 4942), a private foundation is required to distribute for charitable purposes the greater of its minimum investment return (five percent of the fair market value of its investment assets) or its net income.

The bill would repeal the alternative requirement under the foundation payout rule that, under present law, requires a private foundation to distribute any excess of net income over its minimum investment return. The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

7. S. 499—Senator Moynihan

Rollover of Gain on FCC-Ordered Disposition of Broadcast Property

Present law provides for nonrecognition of gain realized on the disposition of broadcast property, pursuant to an FCC order, to the extent the proceeds are reinvested in replacement property which is similar or related in service or use to the property sold or exchanged (Code secs. 1071, 1083(a)). The Internal Revenue Service has ruled that the nonrecognition provisions apply where proceeds from disposition of a newspaper are reinvested in a television station, but not where proceeds from disposition of a television station are reinvested in a newspaper.

The bill would provide for nonrecognition of gain realized on an FCC-ordered disposition of broadcast property where the proceeds are reinvested in a newspaper. The amendments made by the bill would be effective on January 1, 1980.

II. DESCRIPTION OF BILLS

1. S. 388—Senators Hatch and Tower
and
2. S. 446—Senators Symms and Lugar

Tax Treatment of Investment and Wraparound Annuities

Present law

In general

Under present law, tax on interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until amounts characterized as income are withdrawn or annuity payments are received (Code sec. 72(a)). Amounts paid out under a contract before the annuity payments begin, such as policy dividends or payments upon partial surrender of a contract, are first treated as a return of the policyholder's capital and are taxable (as ordinary income) only after all of the policyholder's investment in the contract has been recovered (sec. 72(e)). A portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income (under an "exclusion ratio" test),¹ as are policy dividends paid after annuity payments begin.

A life insurance company which issues an annuity contract is not taxed on its investment income² to the extent that income is required to be added to its policyholder reserves for the annuity contract (secs. 802(b), 804(a), and 809(a)).

Traditional commercial annuities

A commercial annuity contract is a promise by a life insurance company, to pay to the beneficiary a given sum for a specified period, which period may terminate at death. Annuity contracts permit the systematic liquidation of an amount consisting of principal (the pol-

¹ Each annuity payment received is generally allocated between ordinary income and excludable return of capital on the basis of the capital investment in the contract at the time annuity payments begin (the exclusion ratio). This allocation between income and capital continues for all of the annuity payments received by the policyholder even after all capital invested in the contract has been recovered tax-free. If the annuity terminates (for example, by reason of death) before capital is exhausted, no loss deduction is allowed. Under rules applicable to annuities under qualified pension plans, an employee's investment in the contract may be recovered first (Code sec. 72(e)).

² Capital gains are taxed to the insurance company unless the annuity is issued under a tax-qualified pension, profit-sharing, or stock bonus plan, an individual retirement annuity, or a tax-sheltered annuity, and the assets under such arrangements are held in segregated asset accounts that are not part of the general assets of the insurance company (Code sec. 804(a)).

icyholder's capital) and income. The insurance company may take the risk that such amount will be exhausted before the company's liability under the contracts ends but may gain if the liability terminates before it is exhausted.

The starting date for annuity payments may be within one year after the initial premium is paid (an immediate annuity) or may be deferred to a later date (a deferred annuity). The period between the time the first premium is paid for an annuity and the time the first annuity payment is due is referred to as the "accumulation period." Annuity payments may be payable for a period which depends on the date of an individual's death (a life annuity), for a fixed period of time (a period certain annuity), or for the longer of a specified minimum period or life (an annuity for a period certain and life thereafter).

An individual may purchase an annuity by payment of a single premium or by making periodic payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin, in exchange for the cash value of the contract. Partial surrenders are similarly permitted under some annuity contracts.

If either the premium paid for an annuity contract or the annuity benefits under the contract is based on the investment return and the market value of a separate account established by the insurance company, the contract is a "variable annuity contract."

Investment annuities

Under an investment annuity contract, an individual could transfer an asset to an insurance company. (Typically, the transferred asset was a certificate of deposit in a bank or savings and loan association, but investments in mutual funds and certain publicly traded securities were also permitted.) Under the contract, the asset was held in a separate account by the insurer and invested, or reinvested, pursuant to the taxpayer's control.³ The premium paid for the annuity contract and the annuity benefits were based on the investment return and the market value of the assets in the account. The taxpayer could surrender (or partially surrender) the contract at any time before annuity benefits began and receive cash equal to the amount held in the account (less any applicable charges).

Under a 1965 "private letter" ruling and numerous subsequent rulings, the Internal Revenue Service held that the usual rules for taxation of variable annuities applied to investment annuities. Accordingly, (1) income credited to invested assets was not taxed to the insurance company, (2) capital gains on invested assets were taxed to the insurance company unless the contract was held under a tax-qualified retirement arrangement (e.g., a contract under a qualified pension plan), and (3) an investor's tax on earnings on amounts invested under the contract was deferred until amounts were withdrawn or benefits were

³ The contracts typically limited investments to assets which could be readily liquidated, for example, savings deposits, listed securities, or mutual funds. Where appreciated assets are transferred under an investment annuity arrangement, the appreciation is subject to tax in the year of the transfer.

paid. Benefits paid under the contract were taxable as ordinary income after the investment in the contract was recovered.⁴

In 1975, the Service suspended the issuance of rulings as to investment annuities and, after public announcement of the suspension, held meetings with affected issuers. In 1977, after these discussions, the Service announced its changed position on the taxation of investment annuities. Under Rev. Rul. 77-85, 1977-1 C.B. 12, earnings on assets first invested under an investment annuity contract after March 9, 1977 (the date the ruling was released) are taxed to the individual taxpayer currently, without deferral of the tax until benefits are paid under the contract. The Service's position was based upon the conclusion that the individual possessed such substantial incidents of ownership in the assets in the separate account (the insurer's reserve for the contract) that such assets were "owned" by the individual (rather than the insurance company) for income tax purposes.⁵

"Wraparound" annuities

The principles of Rev. Rul. 77-85 (earnings taxed currently to the individual) were recently extended by Rev. Rul. 80-274, 1980-42 I.R.B. 5, to certain "wraparound" annuity contracts. A wraparound annuity is generally the same as an investment annuity except that the individual does not retain control over the investment and the insurer's reserve for the contract may be a separate account or the insurer's general reserve.

Under the wraparound annuity contract described in Rev. Rul. 80-274, an individual could transfer cash, passbook savings, or a certificate of deposit in a savings and loan association to a life insurance company. Under the contract, the asset (reduced by a fee) was deposited by the insurer in a separate account of the originating savings and loan association,⁶ and invested in a certificate of deposit. When the certificate of deposit matured, the insurance company was generally required to reinvest the proceeds in another certificate of deposit. The individual could surrender (or partially surrender) the contract before annuity benefits began and receive cash equal to the amount held in the account (less any applicable charges).

Issue

The issue is whether prior law, which permitted tax deferral under investment annuities and wraparound annuities, should be restored.

Explanation of the bills

Under the bills, which are substantially identical in effect, (1) the gross income of the owner of an investment annuity contract or a wrap-

⁴ The exclusion ratio test applies in computing the income element of an annuity payment under an investment annuity arrangement.

⁵ In litigating challenging Rev. Rul. 77-85, the U.S. District Court for the District of Columbia issued a declaratory judgment that the ruling was unreasonable and that the Internal Revenue Service had exceeded its statutory authority in issuing it. On appeal, the order of the District Court was reversed. The appellate court held that the Anti-Injunction Act (Code sec. 7421(a)) barred relief to the plaintiff, marketers of investment annuities, and therefore did not address the merits of the investment annuity issue. *Investment Annuity, Inc. v. Blumenthal*, 609 F. 2d 1 (D.C. Cir. 1979), *rev'd* 442 F. Supp. 681 (D.D.C. 1977).

⁶ Wraparound annuities could be invested in a mutual fund or publicly traded securities in addition to deposits in a bank or savings and loan association.

around annuity contract, and (2) the tax treatment of the reserves of a life insurance company under such a contract, would be determined without regard to Rev. Rul. 77-85 or Rev. Rul. 80-274. Accordingly, these types of annuity contracts would receive the same tax treatment accorded traditional annuity contracts under present law.

Effective date

The provisions of the bills would apply upon enactment.

Revenue effect

It is estimated that the bills would involve a moderate revenue loss for fiscal year 1981, but could involve substantial revenue losses for future years.

3. S. 464—Senators Durenberger, Moynihan, Baucus, Riegle, and Thurmond

Modifications of Private Foundation Rules

Present law

Payout requirement

The Tax Reform Act of 1969 imposed a series of requirements on private foundations. Under one of these rules (Code sec. 4942), a private foundation is required to distribute currently for its charitable or other exempt purposes the greater of its net income or five percent of the value of its investment assets (called the "minimum investment return").¹

This minimum distribution requirement for a year generally must be met by making the required amount of charitable distributions in that year or in the following year. Graduated sanctions are imposed in the event of failure to distribute the required minimum amount.

These general distribution requirements do not apply to "private operating foundations." In general, a private operating foundation is a foundation which expends substantially all its net income directly for the active conduct of exempt activities and which meets one of three other tests (Code sec. 4942(j)(3)). The term "substantially all" is defined by the Treasury regulations to mean 85 percent or more (Reg. § 53.4942(b)-1(c)).

Under the first test, substantially more than one-half of the assets of the foundation must be devoted directly to the activities for which it is organized or to functionally related businesses. Under the second test, the organization must receive substantially all of its support from five or more exempt organizations and from the general public, and not more than 25 percent of the foundation's support may be received from any one exempt organization. Under the third test, the organization must normally spend an amount not less than two-thirds of the minimum investment return (five percent of the value of its investment assets) directly for the active conduct of activities which constitute the purpose or function for which it is organized and operated.

¹ Prior to the Tax Reform Act of 1976, the minimum investment return was based on a variable percentage of the foundation's investment assets. The variable percentage was determined annually by the Treasury Department, pursuant to statutory authorization, based on the changes in money rates and investment yields since 1969, when the payout rate was established by the Tax Reform Act of 1969 at six percent.

In the Tax Reform Act of 1976, Congress changed the variable percentage to a fixed five percent on the grounds that the six percent rate established by the 1969 Act was too high and that a variable percentage resulted in significant uncertainty in planning grant programs.

Expenditure responsibility

The Tax Reform Act of 1969 also restricted the uses for which a private foundation can spend its resources to expenditures for charitable or other exempt purposes (Code sec. 4945). In order to assure that grants to other organizations will be properly utilized, the Act generally imposed upon the donor foundation the responsibility (called "expenditure responsibility") for determining that its grants are so utilized. There is no exception in present law from the expenditure responsibility rules for small grants.

The expenditure responsibility rules do not apply to grants made to "public charities" (i.e., those organizations described in Code secs. 509(a) (1), (2), or (3)). The category of "publicly supported" charities described in Code section 509(a)(2) includes generally a charitable organization that (1) receives more than one-third of its support for the taxable year from gifts, grants, contributions, membership fees, and certain gross receipts and (2) normally receives not more than one-third of its support for each taxable year from investment income. The Treasury regulations interpret the word "normally" to mean an average of the four preceding taxable years or, if for the current taxable year there is a substantial and material change in the foundation's sources of support, an average of the current year and the four preceding taxable years. For this purpose, "unusual grants" are excluded from the computation (Reg. § 1.509(a)-3(c)).

Under the Treasury regulations, once an organization has been classified as publicly supported, the determination of whether a grant is subject to the expenditure responsibility requirements of Code section 4945 generally will not be affected by the donee's subsequent loss of classification as a publicly supported organization until notice of loss of classification is published. However, a donor foundation may not rely on the donee organization's classification if the donor foundation is responsible for or aware of a "substantial and material" change in the donee organization's sources of support that results in the organization's loss of classification as a publicly supported organization. In general, the donor foundation will not be considered responsible for or aware of such a change in support if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in loss of public charity status, and the information in such statement would not give rise to a reasonable doubt as to the effect of the grant (Reg. § 1.509(a)-3(c)).

The Internal Revenue Service recently published guidelines specifying circumstances under which a donor foundation will not be considered responsible for a "substantial and material" change in support of the donee organization. Under these guidelines, a donor organization generally will not be considered responsible for a substantial and material change in support if the aggregate of gifts, grants, and contributions received from the donor organization for a taxable year does not exceed 25 percent of the aggregate support received by the donee organization from all other sources for the four taxable years immediately preceding the year of the grant (Rev. Proc. 81-6, 1981-10 I.R.B. 41). In such circumstances, the donor foundation can rely on the classification of the donee organization as publicly supported

without risk that its grant will later be treated as causing the donee organization to lose its public charity status (thereby subjecting the donor foundation to penalties for failure to exercise expenditure responsibility).

In addition, the Internal Revenue Service recently published guidelines specifying circumstances under which a grant will be considered "unusual" and hence will not cause the donee organization to lose its status as publicly supported. Under these guidelines, a grant generally will be considered "unusual" where six conditions are met: (1) the grant is not made by a donor foundation which created the donee organization or was a substantial contributor to the donee organization; (2) the grant is not made by a donor organization which is in a position of authority to the donee organization; (3) the grant is made in cash, readily marketable securities, or assets that directly further the exempt purpose of the donee organization; (4) the donee organization has received an advance or final ruling that it is classified as a publicly supported organization; (5) there are no material restrictions imposed on the grant; and (6) if the grant is intended to pay for the operating expenses of the donee organization, the grant is expressly limited to one year's operating expenses (Rev. Proc. 81-7, 1981-10 I.R.B. 42).

Definition of family member

Present law contains a number of restrictions imposed on private foundations (such as prohibitions on self-dealing and excess business holdings) which depend on determinations of "disqualified persons." A "disqualified person" includes a substantial contributor, a foundation manager, or a member of the family of either a substantial contributor or foundation manager (Code sec. 4946). For this purpose, a member of the family includes the spouse, ancestors, and lineal descendants and spouses of lineal descendants of a substantial contributor or foundation manager.

Issues

Payout requirement

The general issue is whether the payout rule applicable to private foundations should be modified to provide that a private foundation is required to distribute only its minimum investment return. A related issue is whether the definition of a "private operating foundation" should be modified so that an operating foundation is required to pay out only the lesser of (1) substantially all its income or (2) substantially all its minimum investment return.

Expenditure responsibility

The first issue is whether an exemption should be provided from the expenditure responsibility rules for small grants and, if so, what should be the amount of such an exemption. The second issue is whether a grant to an organization which the Internal Revenue Service has classified as a public charity should be exempt from the expenditure responsibility rules, even though the donee organization loses its public charity status, unless the grant is made after publication of the donee organization's loss of qualified status, the grant is made after the donor foundation acquires actual knowledge of the donee organiza-

tion's loss of qualified status, or the donor foundation has actual knowledge that the grant will cause the donee organization to lose its qualified status.

Definition of family member

The issue is whether the term "disqualified person" should include lineal descendants of a substantial contributor or foundation manager who are more than two generations younger than such person.

Explanation of the bill

Payout requirement

The bill would repeal the alternative requirement that, under present law, requires a private foundation to distribute any excess of net income over the minimum investment return. Under the payout rule as amended by the bill, a private foundation would be required to make charitable distributions equal to five percent of its net investment assets, without regard to the amount of its income for the year.

The bill would also modify the definition of a private operating foundation. Under the revised definition, an organization would be a private operating foundation if (1) it expends for the active conduct of its exempt activities an amount equal to the lesser of substantially all its income or substantially all its minimum investment return and (2) it meets one of the three alternative tests of present law (relating to use of assets, support, and operating expenditures).

Expenditure responsibility

Small grants.—The bill would provide that a private foundation is not required to exercise expenditure responsibility over a grant to an organization if the aggregate amount of grants made during the year by the foundation (and by all related foundations) to that organization does not exceed \$10,000.

Reliance by donor foundation.—The bill would provide that a grant to an organization which the Internal Revenue Service has determined to be a public charity is not subject to the expenditure responsibility rules, even though the donee organization loses its public charity status, unless (1) the grant was made after the date of publication by the Service that the donee organization has lost its qualified status, (2) the grant was made after the date on which the foundation acquires actual knowledge that the donee organization has lost its qualified status, or (3) the donor foundation has actual knowledge that the grant will cause the donee organization to lose its qualified status. The bill would provide a similar rule for grants by a private foundation to a private operating foundation in connection with the payout requirements of Code section 4942.

Definition of family member

The bill would restrict the category of "disqualified persons" by limiting the persons in the family of a substantial contributor or foundation manager taken into account to the spouse, ancestors, children, grandchildren, and the spouses of children and grandchildren. The effect of this amendment would be to exclude from the definition of family member any lineal descendant who is more than two generations from the substantial contributor or foundation manager.

Effective dates

The changes made by the bill to the payout requirement for private foundations and the definition of private operating foundations would be effective for taxable years beginning after December 31, 1980. The amendments made by the bill to the expenditure responsibility rules would be effective for grants made after December 31, 1980. The amendment made by the bill in the definition of "family member" would be effective on January 1, 1981.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than \$2 million annually.

4. S. 476—Senators Durenberger and Boschwitz

Special Distribution Rule for Private Foundations Constituting Bank Holding Companies

Present law

The Tax Reform Act of 1969 imposed a series of requirements on private foundations. Under one of these rules (Code sec. 4942), a private foundation is required to distribute currently for its charitable or other exempt purposes the greater of its net income or five percent of the value of its investment assets (called the "minimum investment return").¹

This minimum distribution requirement for a year generally must be met by making the required amount of charitable distributions in that year or in the following year. Graduated sanctions are imposed in the event of failure to distribute the required amount.

Issue

The issue is whether a special valuation rule should apply for purposes of determining the distribution requirement in the case of a private foundation which is a bank holding company and which has a substantial portion of its assets consisting of securities in banks, bank-related companies, or a bank holding company.

Explanation of the bill

The bill would provide a special rule for valuing securities of banks and bank-related companies, for purposes of the minimum investment return, in the case of a private foundation which is a bank holding company and which has a substantial portion of its assets consisting of securities in banks, bank-related companies, or a bank holding company. The value would be determined, at the election of the foundation, by capitalizing the dividends paid by such banks and bank-related companies at a rate of six percent (i.e., by multiplying the dividends by 16 $\frac{2}{3}$).

For purposes of this rule, a bank holding company would be any company as so defined in the Bank Holding Company Act of 1956.

¹ Prior to the Tax Reform Act of 1976, the minimum investment return was based on a variable percentage of the foundation's investment assets. The variable percentage was determined annually by the Treasury Department, pursuant to statutory authorization, based on the changes in money rates and investment yields since 1969, when the payout rate was established by the Tax Reform Act of 1969 at six percent.

In the Tax Reform Act of 1976, Congress changed the variable percentage to a fixed five percent on the grounds that the six percent rate established by the 1969 Act was too high and that a variable percentage resulted in significant uncertainty in planning grant programs.

A bank-related company would be any corporation or company which may be acquired by a bank holding company under the provisions of paragraphs (1) or (8) of section 4(c) of the Bank Holding Company Act of 1956.²

Because the capitalization rate specified in the bill (six percent) exceeds the percentage for the minimum investment return (five percent), the minimum investment return with respect to bank securities in the case of a private foundation using the special valuation method under the bill would always be less than the amount of dividends paid on such bank securities. Accordingly, such a private foundation would be required to make distributions for exempt purposes only in the amount of dividends actually paid on such securities.³

The intended beneficiary of the bill is the Otto Bremer Foundation of St. Paul, Minnesota, a private foundation which is a bank holding company. The Bremer Foundation is the sole shareholder of the Otto Bremer Company, also a bank holding company, which owns majority control of 29 banks and 39 bank-related companies.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1971.

Revenue effect

The revenue effect of the bill is indeterminate inasmuch as the effect would depend on ultimate resolution of disagreements between the Bremer Foundation (the intended beneficiary of the bill) and the Internal Revenue Service as to the valuation, for purposes of the foundation payout requirements, of bank securities held by the Foundation. If it were ultimately determined either that the securities have been correctly valued by the Foundation, or that any failure to value the

² A bank holding company is defined generally to mean any company which has control over any bank or over any company that is or becomes a bank holding company under the Bank Holding Company Act (12 U.S.C. sec. 1841(a)(1)). Control is generally defined to mean 25 percent ownership.

Under 12 U.S.C. sec. 1843(a), a bank holding company generally may not acquire direct or indirect ownership or control of any voting shares of any company which is not a bank. The Act provides a number of exceptions to this prohibition.

One of the exceptions allows a bank holding company to acquire shares in companies engaged in one or more of the following activities: (1) holding or operating properties used wholly or substantially by any banking subsidiary of such bank holding company in the operations of such banking subsidiary or acquired for such future use; (2) conducting a safe deposit business; (3) furnishing services to or performing services for such bank holding company or its banking subsidiaries; or (4) liquidating assets acquired before May 9, 1956, or before the company became a bank holding company (12 U.S.C. sec. 1843(c)(1)). The law also exempts ownership or control of shares of any company whose activities are determined by the Board of Governors of the Federal Reserve System to be so closely related to banking or managing or controlling banks as to be a proper incident thereto (12 U.S.C. sec. 1843(c)(8)).

³ To the extent that such a private foundation in fact has effective control over such banks or bank-related companies and is able to use such control to determine the amount of dividends paid on such securities, the foundation could thereby effectively determine the amount that it would be required to distribute with respect to such securities under Code section 4942 (as amended by the bill).

assets correctly was not willful and was due to reasonable cause, there would be no revenue effect from the bill. If it were ultimately determined that the valuation proposed by the Service was correct and also that failure to value the assets correctly was willful or not due to reasonable cause, it is estimated that the bill would reduce budget receipts by an amount in excess of \$10 million, the exact amount depending on the ultimate resolution of the valuation issue and the length of time before such resolution is reached.

5. S. 500—Senator Moynihan

Inflation Adjustment of Income Payout Requirement for Private Foundations

Present law

The Tax Reform Act of 1969 imposed a series of requirements on private foundations. Under one of these rules (Code sec. 4942), a private foundation is required to distribute currently for its charitable or other exempt purposes the greater of its net income or five percent of the value of its investment assets (called the "minimum investment return").¹

This minimum distribution requirement for a year generally must be met by making the required amount of charitable distributions in that year or in the following year. Graduated sanctions are imposed in the event of failure to distribute the required minimum amount.

Issue

The issue is whether the amount of income that a private foundation is required to distribute should be adjusted for inflation, so that the foundation would be required to distribute the greater of its inflation-adjusted income or its minimum investment return.

Explanation of the bill

The bill would reduce the amount of income that a private foundation is required to distribute by the amount of income attributable to inflation. The inflation adjustment would be based on the percentage change in the GNP implicit price deflator for the year preceding the year in which the income is earned. Under the payout rule as amended by the bill, a private foundation would be required to distribute the greater of its inflation-adjusted income or its minimum investment return.

Effective date

The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than \$2 million annually.

¹ Prior to the Tax Reform Act of 1976, the minimum investment return was based on a variable percentage of the foundation's investment assets. The variable percentage was determined annually by the Treasury Department, pursuant to statutory authorization, based on the changes in money rates and investment yields since 1969, when the payout rate was established by the Tax Reform Act of 1969 at six percent.

In the Tax Reform Act of 1976, Congress changed the variable percentage to a fixed five percent on the grounds that the six percent rate established by the 1969 Act was too high and that a variable percentage resulted in significant uncertainty in planning grant programs.

6. S. 501—Senator Moynihan

Repeal of Alternative Income Payout Requirement for Private Foundations

Present law

The Tax Reform Act of 1969 imposed a series of requirements on private foundations. Under one of these rules (Code sec. 4942), a private foundation is required to distribute currently for its charitable or other exempt purposes the greater of its net income or five percent of the value of its investment assets (called the "minimum investment return").¹

This minimum distribution requirement for a year generally must be met by making the required amount of charitable distributions in that year or in the following year. Graduated sanctions are imposed in the event of failure to distribute the required minimum amount.

Issue

The issue is whether the payout requirement applicable to private foundations should be modified to provide that a private foundation must distribute only its minimum investment return.

Explanation of the bill

The bill would repeal the alternative requirement under the foundation payout rule that, under present law, requires a private foundation to distribute any excess of net income over the minimum investment return. Under the payout rule as amended by the bill, a private foundation would be required to make charitable distributions equal to five percent of its investment assets, without regard to the amount of its income for the year.

Effective date

The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than \$2 million annually.

¹ Prior to the Tax Reform Act of 1976, the minimum investment return was based on a variable percentage of the foundation's investment assets. The variable percentage was determined annually by the Treasury Department, pursuant to statutory authorization, based on the changes in money rates and investment yields since 1969, when the payout rate was established by the Tax Reform Act of 1969 at six percent.

In the Tax Reform Act of 1976, Congress changed the variable percentage to a fixed five percent on the grounds that the six percent rate established by the 1969 Act was too high and that a variable percentage resulted in significant uncertainty in planning grant programs.

7. S. 499—Senator Moynihan

Rollover of Gain on FCC-Ordered Disposition of Broadcast Property

Present law

Present law (Code sec. 1071) provides for nonrecognition of gain realized on the sale or exchange of property (including stock) if (1) the disposition is certified by the Federal Communications Commission (FCC) as necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the FCC with respect to the ownership and control of "radio broadcasting stations," and (2) if the taxpayer elects to treat the disposition as an involuntary conversion. Pursuant to such an election, gain is not recognized to the extent that the taxpayer purchases replacement property that is similar or related in service or use to the property sold or exchanged (Code sec. 1033(a)).

Treasury regulations provide that the term "radio broadcasting" as used in Code section 1071 includes telecasting (Treas. Reg. § 1.1071-1(d)). Neither the statute nor the regulations expressly include other communications media property within the definition of "radio broadcasting."

In Rev. Rul. 78-269, 1978-2 C.B. 210, the Internal Revenue Service held that gain is not recognized under Code sections 1071 and 1033 where a corporation divests itself, pursuant to an FCC order and certification, of stock in a newspaper publishing company, and reinvests in stock of a television broadcasting station. In a later "private letter" ruling, the Service held that gain must be recognized where a corporation, pursuant to an FCC order and certification, divests itself of a television station and reinvests in newspaper stock.¹ In the private letter ruling, the Service distinguished its holding in Rev. Rul. 78-269 on the basis that a reinvestment in newspaper stock did not constitute an investment in broadcast property (within the meaning of Code sec. 1071) or in any property similar or related in service or use to the television station sold or exchanged.

Under present law, the FCC may order a taxpayer who owns multiple communication properties—for example, two television stations, a television station and a radio station, or a television station and a newspaper—within the same broadcast area to dispose of all but one of the properties. The FCC generally does not order the taxpayer to dispose of a particular station within the area of its multiple broadcast ownership. Rather, the taxpayer generally may decide which broadcasting media is sold or exchanged pursuant to such an FCC order.

¹ IRS Letter Ruling 8050025, September 16, 1980.

Issue

The issue is whether gain should be recognized pursuant to an FCC-ordered and certified disposition of a television station if the proceeds are reinvested in a newspaper.

Explanation of the bill

The bill would extend the nonrecognition provisions of present law, relating to "rollover" of gain on certain FCC-ordered divestitures, to situations in which the proceeds are reinvested in newspaper property. Also, the bill would make a technical amendment to Code section 1071 by amending the statute to refer specifically to FCC-ordered dispositions of television broadcasting stations as well as to radio broadcasting stations.²

The amendments which would be made by the bill are intended to apply to the FCC-required disposition of television station WWNY in Watertown, New York, by Johnson Newspaper Corporation, and to other similarly situated taxpayers where disposition proceeds are reinvested in a newspaper.

Effective date

The amendment made by the bill would be effective on January 1, 1980.

Revenue effect

It is estimated that this bill would reduce budget receipts by an amount not to exceed \$10 million annually.

² This technical amendment would be consistent with existing Treasury Reg. § 1.1071-1(d).



