GENERAL EXPLANATION

OF THE

REVENUE ACT OF 1971

H.R. 10947, 92D CONGRESS, PUBLIC LAW 92–178

PREPARED BY THE

STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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CONGRESS OF THE UNITED STATES

Joint Committee on Internal Revenue Taxation

LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D.C., December 15, 1972.

Hon. RUSSELL B. LONG, *Chairman*, and
Hon. WILBUR D. MILLS, *Vice Chairman*,
Joint Committee on Internal Revenue Taxation,
U.S. Congress, Washington, D.C.

DEAR MESSRS. CHAIRMEN: Following the enactment of the Tax Reform Act of 1969, the Joint Committee staff prepared, and made available to the public, a general explanation of that act. As was noted at that time, while committee reports explain the position of the House Committee on Ways and Means and the position of the Senate Committee on Finance, these positions do not in all cases correspond with the position taken by Congress in the legislation as finally enacted. The general explanation prepared by the staff on the 1969 act was designed to fill that gap, and interest in the explanation suggested that it was to some degree successful in reaching that objective. The general explanation which follows attempts to provide the same type of information with respect to the Revenue Act of 1971.

This document, therefore, represents the effort of the staff of the Joint Committee on Internal Revenue Taxation to provide an explanation of the Revenue Act of 1971 as finally enacted. It is an attempt by the staff to write the equivalent of what it believes would be the type of explanation which might have been prepared with respect to the legislation as finally enacted if the legislative process called for such an explanation. For the most part, where provisions which were unchanged in conference were described in either the House or Senate report, this explanation is carried over in this document. No attempt is made here, however, to carry the explanation further than is customary in the case of committee reports to deal with issues which, under the regular procedures, are explained in regulations or rulings.

This document is presented in much the same manner as a committee report. The first section in the document is a brief summary of the various provisions; the second part presents the reasons for the legislation; the third part, the revenue estimates on the legislation as finally enacted; and, finally, the fourth part is a general explanation of the provisions appearing in the order in which they appear in the public law.

This material has basically been prepared by the staff of the Joint Committee on Internal Revenue Taxation, but we wish to thank the Tax Legislative Counsel's office, the International Tax Counsel's office, and the Office of Tax Analysis of the Treasury Department for reviewing the material prior to its publication and giving us its comments on the various sections. The Joint Committee staff, of course, assumes full responsibility for the contents of this document. It is hoped that this document will be useful as source material on the Revenue Act of 1971.

Sincerely yours,

LAURENCE N. WOODWORTH,
Chief of Staff.

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I. SUMMARY

The Revenue Act of 1971 was designed to provide a balanced program of tax reductions for individuals and tax incentives for business. The purpose of the Act was to—

- put the then lagging economy on the high growth path.
- increase the number of jobs and diminish the high unemployment rate.
- relieve the hardships imposed by inflation on those with modest incomes.
- provide a rational system of tax incentives to aid in the modernization of our productive facilities.
- increase our exports and improve our balance of payments.

It was expected that this Act would attain the objectives set forth above by working in cooperation with other governmental actions, including the price control program and other actions taken to improve our balance of payments and strengthen the dollar abroad.

The Act is expected to reduce prior law tax liabilities by about \$1.7 billion in the calendar year 1971, \$8.0 billion in 1972, and \$6.1 billion in 1973.

The principal actions provided by this Act to aid in the attainment of the objectives set forth above are:

1. A 7-percent job development investment credit was provided. The credit generally became effective on August 15 (although also effective with respect to earlier deliveries where orders were placed after the end of March). At the same time, however, the liberal depreciation system (Asset Depreciation Range) provided by administrative action in January of this year was modified somewhat to remove an element providing additional depreciation for assets in the first year of their use (referred to as the "first-year convention"). The investment credit was expected to make from \$1.5 billion in 1971 to \$3.9 billion in 1973 available to businesses which expand and modernize their equipment and facilities. The modification in the depreciation system (ADR) offsets the initial revenue impact of the investment credit by forestalling tax reductions which would otherwise occur as a result of administrative action. These reductions which were forestalled would have amounted to \$2.1 billion in 1971, decreasing over later years to \$1.7 billion in 1972 and \$1.5 billion in 1973.

2. Significant individual income tax reductions were provided for those who were hardest hit by inflation and where the greatest impact on increased consumer spending could be anticipated. Under the Act these reductions began in 1971. For 1971 the Act increased personal exemptions from \$650 to \$700 effective for one-half the year (\$675 for the entire year). In addition, the minimum standard deduction was modified to provide additional relief in the lower income tax brackets in 1971. These changes provided an immediate tax reduction for 1971 of \$1.4 billion. For 1972 and subsequent years, the Act further

increased all personal exemptions to $750. Also the minimum standard deduction, or low-income allowance, was increased from $1,000 to $1,300, and the percentage standard deduction was further increased to 15 percent (already scheduled to go to 14 percent with a $2,000 ceiling in 1972).

This latter action gave assurance that the individual income tax would not be imposed below the poverty level. These individual income tax reductions for 1972 are expected to amount to approximately $3.2 billion. This is in addition to a reduction of $2.7 billion (compared to 1971 tax levels) which occurs automatically in 1972 as a result of the Tax Reform Act of 1969.

In addition, single individuals and working couples who support a child under the age of 15 or disabled dependents or a disabled spouse in the household are, subject to certain limitations, granted a special deduction of up to $400 a month for expenses for child care and domestic help which are incurred to permit them to be gainfully employed.

3. The 7-percent manufacturers excise tax on passenger automobiles was repealed effective the day after the date of enactment of the Act, that is, December 11, 1971. For those taxes paid for the period back to August 15, 1971, consumer refunds or floor stocks refunds were provided. In addition, the Act also repealed the 10-percent excise tax on light-duty trucks (those weighing 10,000 pounds or less gross vehicle weight) with consumer refunds or floor stocks refunds for the period after September 22, 1971. These light trucks, to a substantial degree, are used as a means of personal transportation. These tax cuts were expected to reduce tax liabilities by approximately $0.9 billion in the calendar year 1971, $2.6 billion in 1972, and $2.3 billion in 1973.

4. Tax deferral was provided for export income of domestic international sales corporations (DISC's) effective with the calendar year 1972. In general, the Act allows deferral for one-half of the DISC's income. Under this provision, reductions in tax liabilities of something like $100 million are expected for 1972 and $170 million for 1973.

5. The Act made a series of structural improvements in the tax law, including some which are clarifications of prior law. These provisions relate to:

(a) a limitation in certain cases on the standard deduction of individuals receiving certain unearned income,

(b) a limitation on carryovers of unused credits and capital losses in the case of certain changes in ownership,

(c) amortization of expenditures for on-the-job training and for child care centers,

(d) a revision in the definition of a net lease,

(e) a modification in the application of the farm loss provision in the case of subchapter S corporations,

(f) a modification in the case of capital gain distributions of accumulation trusts,

(g) a provision that income from the Virgin Islands may not in certain cases be treated as Western Hemisphere Trade Corporation income,

(h) a clarification of the application of the minimum tax to foreign capital gains on which little or no foreign tax is imposed,

(i) a clarification of the right of taxpayers to bring cases into courts under tax treaty provisions,

(j) a broadening of the nondeductibility of illegal bribes and kickbacks (and other illegal payments),

(k) a clarification and perfection of the provision added by the 1969 Tax Reform Act relating to activities not engaged in for profit (primarily farming activities),

(l) a revision of the treatment of dividends paid in property (other than money) to foreign corporations,

(m) a clarification and perfection of the original issue discount provision in its application to foreign persons,

(n) treating as domestic income or loss the income or loss involved in the case of aircraft and shipping leases of financial institutions even though the leases may involve ships or aircraft used abroad,

(o) an exemption in certain cases from the industrial development bond rule which provides that these bonds are not obligations the interest on which is excluded from tax (i.e., the exemption for small issues and the exemption for facilities for furnishing water), and

(p) imposition of a criminal penalty in certain cases where there is a disclosure of information by preparers of income tax returns.

6. The Act provided a special tax credit for employing welfare recipients and made a number of improvements in the existing Work Incentive Program (WIN) for welfare recipients. The tax credit provided equals 20 percent of the wages paid to the employed welfare recipients in their 12 months of employment (but would be recaptured if the employment does not last at least 24 months).

7. The Act provided tax incentives for contributions to candidates for public office by allowing an individual a credit against his income tax for one-half of the political contributions made during a taxable year (with a maximum credit of $25 in the case of a joint return and $12.50 in the case of the return of a single person or a married person filing separately). In lieu of this credit, the Act also allowed a taxpayer to deduct from his adjusted gross income the amount of political contributions made during the taxable year (up to $100 in the case of a joint return or $50 in the case of the return of a single person or a married person filing separately).

8. The Act also provided public financing as an alternative way of financing the general election campaigns of presidential and vice-presidential candidates. The public financing is provided by a "check-off" or designation system in which an individual can designate that $1 of his tax liability be set aside in a special account in the Presidential Election Campaign Fund for the candidates of the political party specified by the taxpayer, or, alternatively, set aside in a nonpartisan general account in the Fund. (In the case of a joint return with a taxable income of $2 or more, each spouse may designate $1 of the liability for this purpose.) The amounts are made available to the candidates based on specified formulas and must be appropriated by the Congress through the normal appropriation process in order to be paid. This provision takes effect on January 1, 1973, that is, the check-off system will apply to tax returns filed for the calendar year 1972 and subsequent taxable years; however, the first election to which the provision will apply will be the 1976 presidential election.

II. REASONS FOR THE ACT

The Congress adopted the 1971 Revenue Act because the performance of the economy had been unsatisfactory. The growth of our gross national product was small, unemployment was too high, and capital goods expenditures were hardly growing at all. Despite these factors, which would usually point toward deflation, the economy was unable to shake the persistent inflationary trend of prices. All this was compounded by our serious adverse balance of trade and the accompanying crisis in the position of the dollar abroad.

In 1971—after adjustment for price increases—the economy grew at a real rate of only about 3 percent. A major—but not the only—factor contributing to this inadequate rate of growth was an abnormally low rate of capital spending. The latest survey (available before the adoption of the Act indicated an increase of only slightly more than 2 percent in plant and equipment spending in 1971. In real terms, after adjustment for inflation, this actually represented a decline from 1970. (The survey further showed that in the first half of 1972, plant and equipment spending was expected to rise 6½ percent above the second half of 1971. However, this projected increase appeared to anticipate the stimulating effect of the investment credit and other changes provided by the 1971 Revenue Act.)

Unemployment levels also remained too high. The unemployment rate averaged 5.9 percent for 1971, substantially above the 3.5 percent rate for 1969 and the 4.9 percent rate for 1970. The unemployment rate reached 6.2 percent in May 1971 and, after a modest decline in June, started to rise again in July. It again went over the 6-percent level in August and stood at 6 percent in September. In October, the rate of unemployment again declined to the July level of 5.8 percent, but in November it rose to 6 percent and in December to 6.1 percent. Accordingly, the unemployment rate showed no consistent inclination to return to the 4-percent level which represents the generally accepted full employment rate. Concern over unemployment, in turn, caused individuals to be more conservative in their spending, sending the consumer savings rate to the very high level of 8.2 percent in the second quarter of 1971 and 7.7 percent in the third quarter. This, interacting with low capital expenditures by business, contributed to the high unemployment rate.

Despite the unsatisfactory levels of employment and production existing in 1971, prices continue to rise sharply prior to the adoption of the wage-price freeze. Almost two-thirds of the increase in the gross national product in 1971 was attributable to price increases. In the 12-month period ending in August of 1971, the consumers price index rose 4.5 percent and the wholesale price index 4 percent. There were signs, however, that the wage-price controls had a beneficial impact in dampening inflation. In the 3 months ending on November 30, the consumers price index increased 0.4 percent on a seasonally adjusted basis. In the same 3-month period, the wholesale price index on a seasonally adjusted basis declined more than 0.3 percent.

Our balance-of-payments position also deteriorated badly. In the second quarter of 1971, our balance-of-payments deficit ran at an annual rate of about $23 billion on a net liquidity basis and at an annual rate of about $20 billion on an official reserve transactions basis. In the third quarter of 1971, the balance-of-payments deficit increased to an annual rate of $37 billion on a net liquidity basis and $48.5 billion on an official reserve transactions basis.

We no longer have a trade surplus on goods and services. Instead of surpluses ranging from $7.1 billion in 1965, $2 billion in 1969 and $3.6 billion in 1970, the surplus ran at an annual rate of only $104 million in the second quarter of 1971 and declined further to a $24 million deficit at an annual rate in the third quarter of 1971. This culminated in the dollar crisis in August, when the United States terminated the convertibility of dollars into gold. These difficulties in our balance of payments are, of course, a result of a number of complex factors including inflation at home and discriminatory trade practices abroad. But they are also a result of the fact that our tax policies did not adequately encourage investment in more modern and efficient machinery which would enable our businessmen to compete more effectively in foreign markets.

In designing a tax program to ameliorate these serious economic problems, the Congress was guided by certain broad considerations. It sought a balanced program to provide fair relief to both individuals and business. In this the Congress was guided not only by the need to adopt a proposal which is fair, but also by the fact that the restoration of sound and vigorous economic conditions required the stimulation of both consumption by individuals and investment by business.

In view of the economic situation, the Congress concluded that the tax reductions and incentives should begin to take effect as soon as possible. These reductions were designed to be large enough to stimulate the economy and yet not be so large as to create a new wave of inflationary pressure. In other words, the Congress provided the level and type of tax reductions included in this revenue act in the belief that they would be sufficient to increase the Nation's output and provide additional jobs, yet not add to inflation. As output increases and the economy moves closer to desired high-income levels, unit costs can be expected to decline and productivity increase. Despite this, however, without two closely related developments, it is doubtful that the Congress would have been able to construct a tax reduction bill which did not have a serious inflationary impact. First, the administration imposed wage-price controls. Second, the administration announced its intention to cut Federal expenditures for fiscal year 1972 by $4.6 to $5 billion below previously planned levels. Such expenditure control is an essential part of the program to check inflation.

The 1971 Revenue Act provided substantial tax reductions to individuals and substantial tax incentives to business in order to bolster the economy. The tax reductions under the Act are estimated at $1.7 billion in calendar 1971, $8.0 billion in calendar 1972, and $6.1 billion in calendar 1973. When combined with the $2.7 billion of individual income tax reduction automatically scheduled to take effect in calendar year 1972 over 1971 under the provisions of the 1969 Tax Reform Act, the tax reduction provided in calendar 1972 will total $10.7 billion.

Job development investment credit and accelerated depreciation

In view of the fact that lagging investment in machinery and equipment is one of the principal causes of present depressed economic conditions, the 1971 Act provided a job development credit along the lines of the investment credit repealed in 1969. The new credit amounted to 7 percent of eligible property (4 percent for public utility property) acquired after August 15, 1971.

In addition, the credit was extended to property ordered after March 31, 1971, to avoid discriminating against those who took action on or after that date to acquire eligible assets on the basis of assurances as to the availability of the credit made by the Secretary of the Treasury, after consultation with the ranking members of the congressional tax-writing committees. This assurance was given to avoid further deferment of investments which were already at an unduly low level.

As a general rule, foreign property ordered after August 15, 1971 (or whose construction was begun after that date), was not eligible for the investment credit during the period when the 10-percent import surcharge applied. However, the President terminated the import surcharge effective after December 19, 1971, so that this exclusion from the investment credit generally applied only to foreign property ordered (or whose construction was begun) after August 15, 1971, and before December 20, 1971.

The Act gave the President the authority to continue the exclusion of foreign property from the investment credit after expiration of the 10-percent surcharge if he determines that the foreign country concerned makes use of nontariff trade restrictions. In addition, the President was given the authority to allow the investment credit to be extended to foreign property retroactively to any date after August 15, 1971, where he determined this to be in the public interest.

The new credit is expected to bolster the economy and create additional jobs by encouraging expenditures on machinery and equipment which were sagging badly in 1971. In this connection, attention is called to the following chart which shows the close correlation between machinery orders and availability of the investment credit.

Moreover, over the long run, the job development credit is expected to be of material assistance in combating inflation. An increased flow of goods into the market is the best long-run assurance we can have of keeping prices down.

Finally, by making our productive facilities more efficient the new credit will help our exporters to compete for foreign markets and improve our balance of payments.

The Congress also reexamined the system of depreciation introduced by the Treasury Department by administrative action in 1971—The Asset Depreciation Range System (ADR)—in light of the provision adopting the job development credit. It concluded that the combined stimulative effect of these two measures was too great. As a result, the Act removed the first-year convention under ADR which, in effect, treated all property placed in service during a year the same as if it were placed in service on the first day of the second quarter of the year for depreciation purposes. This action, in effect, restored the prior convention under which property, in effect, was considered placed in service at the middle of the year for purposes of depreciation.

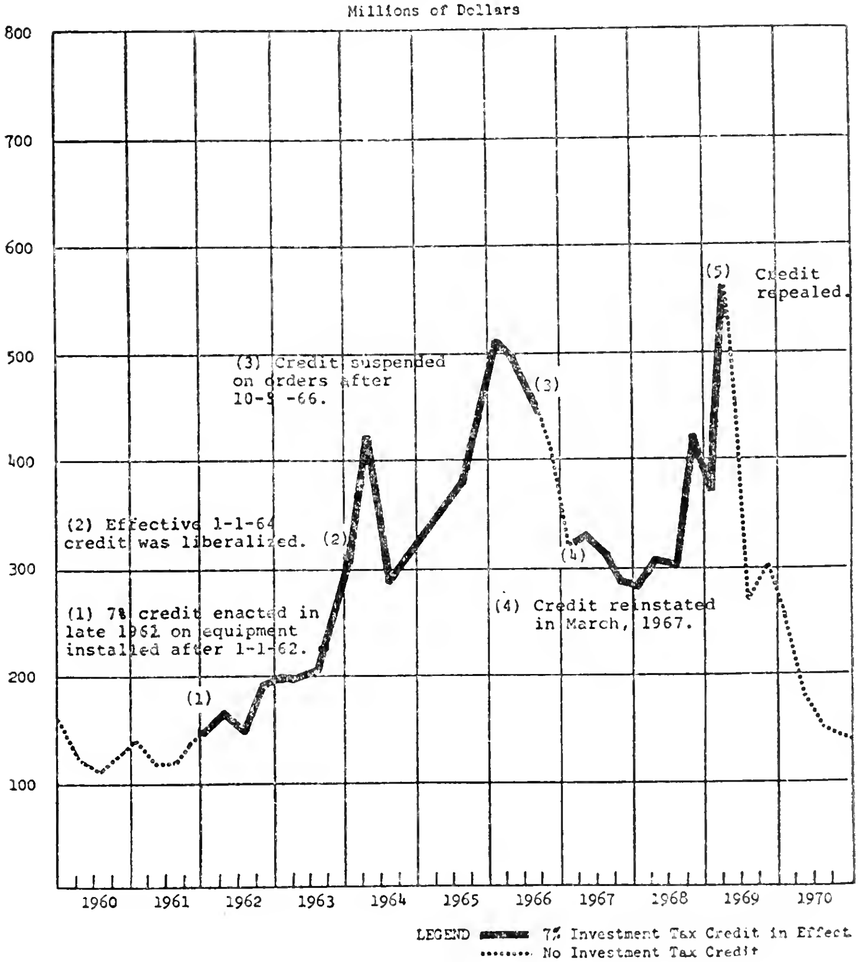
The combined effect of this change and the adoption of the job development credit was to increase business taxes by an estimated $600 million in calendar year 1971 and to decrease business taxes by an estimated $1.9 billion in calendar year 1972 and $2.4 billion in calendar year 1973. However, since the tax effect of withdrawing the three-quarter year rule originally provided by ADR becomes substantially less in later years, business firms will eventually benefit from the full amount of the job development credit with only a modest offset for the withdrawal of benefits resulting from elimination of the first-year convention provided by ADR.

MACHINE TOOLS

Domestic New Orders

Quarterly

Millions of Dollars



Tax reduction for individuals

Individuals receive a substantial share of the total tax benefits provided by the Act. It was believed that this is desirable because of the need to increase consumption and to aid low-income individuals who have been severely burdened by inflation.

In calendar year 1972, $3.2 billion (or 40 percent) of the total tax reduction provided by the Act will accrue to individuals through liberalization of exemptions and the standard deduction. When the tax cuts provided by the Act are combined with the automatic tax cuts already scheduled to take effect in 1972, individuals will receive a reduction of $5.9 billion from these provisions, or 55 percent of the total.

This effect is secured in part by accelerating the effective dates of tax relief automatically scheduled to take effect under the provisions of the 1969 Tax Reform Act.

In view of the depressed economic conditions existing at the time the 1971 Act was considered, the Congress believed it was desirable to begin the tax relief to individuals as early as possible in 1971, rather than to wait until 1972. Accordingly, the Act speeded up the effective dates of two tax relief measures of the 1969 Act to make them effective in calendar year 1971. First, it increased the exemption level from $650 to $700 effective July 1, 1971 (this, in effect, moved the personal exemption for the entire year of 1971 to $675). Second, it provided that the full low-income allowance of $1,050 was to be available in 1971 without reduction of the allowance where income exceeded nontaxable levels. This was achieved by eliminating the so-called phaseout provision which operated to reduce the low-income allowance where income in excess of specified amounts was received. This was scheduled for elimination in 1972 under the 1969 Act (but with a drop in the low-income allowance to $1,000).

For 1972, the Act provided three changes which grant substantial tax relief to individuals. First, the $750 personal exemption level, which under the 1969 Act was to be effective on January 1, 1973, was made effective as of January 1, 1972. Second, the percentage standard deduction was increased to 15 percent of adjusted gross income with a $2,000 ceiling in 1972. Under the 1969 Act, the maximum percentage standard deduction was to be 14 percent of adjusted gross income in 1972 and was not to reach the 15-percent rate until 1973.

A third change effective for 1972 increased the low-income allowance from the $1,000 level that would otherwise have applied in that year to $1,300. This change in the low-income allowance represents a liberalization increasing the level of the allowance provided by the 1969 Act. This change recognized that, as a result of inflation, the previous level of the low-income allowance was not sufficient to achieve its purpose of preventing hardship for low-income people living at, or near, the poverty level.

The effect of the increased low-income allowance together with the higher personal exemption was to remove Federal tax liability for individuals and families living below the poverty level. All individual income taxpayers benefited from the exemption increases. About 25 million tax returns also benefited from the increased low-income allowance and the combination of the low-income allowance and exemption increases made 2.8 million tax returns nontaxable.

The Act also allowed single individuals and working couples who support a child under the age of 15 or disabled dependents or disabled spouses in the household to deduct domestic help expenses and child care expenses incurred in order to permit them to be gainfully employed. Such individuals were permitted to deduct up to $400 a month for child care and domestic help expenses where these expenses are incurred in the home. The $400 deductible amount also covers child care expenses outside of the home up to $200 a month in the case of one child, $300 a month for the care of two children and $400 a month for the care of three or more children.

In the case of married couples, this deduction is available only where both spouses are working or one is disabled. For single people and married couples with combined incomes above $18,000 the deduction is phased out by 50 cents for each dollar of income above $18,000.

For wages paid after January 15, 1972, withholding rates were adjusted to reflect the tax reliefs granted to individuals under the 1971 Revenue Act and to prevent approximately $2 billion of underwithholding which would otherwise result.

Repeal of excise tax on autos and small trucks

Consumers were given additional relief and further stimulus was provided for production in an important industry by repeal of the 7-percent manufacturers tax on automobiles effective August 16, 1971. In addition, the Act repealed, effective September 23, 1971, the 10-percent tax on small trucks with a gross vehicle weight of 10,000 pounds or less and the taxes on trailers and semitrailers of 10,000 pounds or less which are suitable for use with light-duty trucks, and also repealed the taxes on containers for use with trucks for solid waste disposal and on urban mass transit buses. Provision was made for tax refunds on items sold on or after the effective repeal dates.

The Congress anticipated that repeal of the excise tax on automobiles would do much to directly create additional jobs and stimulate consumer spending. Repeal of the excise tax on automobiles was expected to reduce car prices on the average by about $200 per car. The administration has estimated that this reduction will result in 600,000 additional domestic automobile sales and 150,000 additional jobs, not counting dealer employees.

Repeal of the tax on autos also contributed to the equity of our tax system. The Congress previously recognized that this tax should not be a permanent part of our tax system by enacting legislation providing for the periodic reduction of this tax until it would have been eliminated on January 1, 1982. The action taken in the 1971 Act continued the trend begun in 1965 to repeal excise taxes which place discriminatory tax burdens on the consumers and producers of the taxed products.

Automobile manufacturers gave assurances that the tax reductions would be passed on to consumers in the form of reduced prices. The Administration is to exercise all possible diligence and surveillance to see that the tax reductions are, in fact, passed on to consumers. In addition, the Council of Economic Advisers is to review vehicle prices and report periodically to the Congress on the extent to which the tax reductions are passed on to consumers.

The tax on small trucks was repealed in view of the fact that these small trucks are used to a considerable extent by farmers and other individuals for similar purposes as passenger automobiles.

Domestic International Sales Corporation (DISC)

To provide tax incentives for U.S. firms to increase their exports, the Act provided tax deferral for export-related profits. This tax deferral is granted on profits so long as they are retained in a new type of U.S. corporation known as a Domestic International Sales Corporation or a "DISC." The requirements for qualification as a DISC in general are that substantially all of the corporation's gross receipts and assets must be export related. When the profits of the DISC are distributed to its shareholders as dividends or are otherwise realized by them as income, they are taxable to them in full at that time.

Under the provision, a parent corporation is allowed to sell its export products to the DISC at prices which permit the DISC to earn up to the greater of 4 percent on sales or 50 percent of the combined income from the manufacturing and selling of the exports (plus, an amount equal to 10 percent of export promotion expenses and 10 percent of half of shipping expenses incurred from shipping in U.S. flag ships and U.S. airplanes).

To avoid granting undue tax advantages to the DISC's, the deferred tax treatment is limited to one-half of the export profits of the DISC. In addition, to provide assurance that tax-deferred DISC profits which are loaned to a related U.S. manufacturing company producing for export are not used for foreign manufacturing facilities, the Act provided that the tax deferral is to terminate if these profits are invested in foreign plant or equipment.

Tax credit for salaries paid under work incentive programs

The Act contains a provision designed to encourage the hiring of individuals who otherwise would be on welfare. It granted employers an income tax credit equal to 20 percent of the wages paid during the first 12 months of employment of an individual hired under a work incentive program—WIN—established under the Social Security Act. In order to qualify for the credit, the employer must retain the WIN employee for at least one additional year after the 12 months of employment, unless the employee leaves his employment voluntarily, becomes disabled or it is determined under the State unemployment compensation law that the employee was discharged for misconduct. Any unused credits can be carried back to the three preceding taxable years and carried forward to the next seven taxable years.

Political contributions and public financing of presidential and vice-presidential campaigns

To encourage more widespread financing of political campaigns, an individual is allowed an income tax credit for one-half of his political contributions during the year up to a maximum credit of $12.50 (or $25 in the case of a joint return of a husband and wife). Alternatively, the taxpayer is allowed an itemized deduction for political contributions made by him during the taxable year up to a maximum amount of $50 (or $100 in the case of a joint return). This credit or deduction is available for political contributions made to candidates for nomination or election to Federal, State or local office in a primary, general, or special election. In addition, contributions may be made to a political committee. The credit or deduction is available only for contributions made after 1971.

Public financing also was provided for presidential and vice-presidential general election campaigns by the so-called check-off system starting with income tax returns for the calendar year 1972. Under this system an individual can designate that $1 of his tax liability (and in the case of a joint return with a taxable liability of $2 or more, each spouse may designate that $1 of the liability) is to be set aside in the Presidential Election Campaign Fund in a special account for the candidates of the party of his choice or in a general nonpartisan fund. If the taxpayer makes no designation, nothing is to be set aside. The amounts checked off and designated into the accounts in the fund are to be available to presidential and vice-presidential candidates who elect public financing beginning with the 1976 general presidential election campaign. These amounts may be paid to the candidates, however, only after they have been so appropriated by Congress through the normal appropriation process.

86-514—72——2

III. REVENUE EFFECTS

Table 1 shows the overall impact of the Revenue Act of 1971 on calendar year tax liability and fiscal year tax receipts. As indicated by this table, the Act is expected to reduce tax liability by a net $1.7 billion in calendar year 1971, $8.0 billion in 1972, and $6.1 billion in 1973. It is estimated that fiscal year receipts will be reduced by $4.4 billion in fiscal year 1972, $6.9 billion in 1973, and $6.1 billion in 1974.

As indicated in Table 1, the net reduction in tax liability (and receipts) results from a combination of increases in liability (and receipts) offset by decreases. The increases derive from elimination of the ¾ year convention from the Asset Depreciation Range (ADR) System, denial of the standard deduction to the unearned income of taxpayers who are dependent children of other taxpayers, and imposition of an excise tax on tires of imported automobiles; the major decreases are effected through liberalization of the exemption and standard deduction provisions of the individual income tax, provision of a household-help deduction and liberalization of the child-care deduction, reinstatement of the investment credit, provision of a tax credit to employers of public assistance recipients, provision of a tax credit for political contributions, repeal of the automobile and small truck excise taxes, and providing tax deferral for domestic international sales corporations (DISC).

Table 2 breaks down the estimates in Table 1 on the basis of the impact of the various increases and decreases on individuals in a nonbusiness capacity and their impact on business (incorporated and unincorporated). Thus, under the Act the tax liability of individuals in a nonbusiness capacity is estimated to be decreased by $2 billion for calendar year 1971, by $5.2 billion for calendar year 1972, and by $2.8 billion for calendar year 1973. Corporate business and individual business combined are estimated to have their tax liability increased by $340 million for calendar year 1971, decreased by $2.8 billion for calendar year 1972, and decreased by $3.3 billion for calendar year 1973. Also set forth in Table 2 are the net fiscal year tax changes for individuals in a nonbusiness capacity and for corporate and unincorporated business combined. Individuals in a nonbusiness capacity are shown to pay $3.7 billion less in fiscal year 1972, $4.2 billion less in fiscal year 1973, and $2.7 billion less in fiscal year 1974. Corporate and unincorporated business combined are shown to pay $670 million less in fiscal year 1972, $2.8 billion less in fiscal year 1973, and $3.4 billion less in fiscal year 1974.

Table 3 shows, by adjusted gross income class, for each of the calendar years 1971–1973, individual income tax liability and the amount and percentage of change in tax liability under the Act. The percentage reduction for 1971 amounted to 10.4 percent for tax returns with income up to $3,000 and decreases from that level to a very small percentage change for returns with income of $15,000 and over. For 1972, the reductions amount to 36.9 percent for returns with income up to $3,000 and decrease gradually to a reduction of less than one percent for returns with income of $100,000 and over.

Table 4 breaks down the changes in individual income tax liability set forth in table 3 into changes attributable to each of the sources of change under the Act. Thus, the $1.3 billion net of tax reduction in 1971 is broken down in table 4 into the contribution of the liberalized exemption and standard deduction provisions ($1.4 billion), the contribution of reinstatement of the investment credit ($305 million), and the offsetting tax increase contributed by elimination of the ¾-year convention from the ADR System ($420 million). Similarly, 1972's net tax reduction ($3.6 billion) is made up of a $3.1 billion reduction attributable to exemption and standard deduction increases, a $725 million reduction attributable to the investment credit, a $145 million reduction attributable to a household service and child care deduction, a $99 million reduction attributable to the tax credit for political contributions, a $340 million increase attributable to depreciation changes, and a $70 million increase attributable to denial of the standard deduction to the unearned income of taxpayers who are dependent children of other taxpayers.

Table 5 is a schematic outline of the standard deduction and personal exemption provisions under the Revenue Act of 1971 as compared to the provisions under prior law for each of the calendar years 1971, 1972, and 1973 and thereafter. Thus, this table sets forth the specific provisions which result in (a) the estimated decreases in individual income tax liability shown in columns (2), (3), and (4) of Table 4, (b) the estimated increase in nontaxable returns shown in Table 6, and (c) the estimated number of taxable returns switching from itemizing deductions to use of the standard deduction shown in Table 7.

Table 6 indicates, by adjusted gross income class, the number of individual income tax returns which become nontaxable as a result of the exemption and standard deduction provisions under the Act. It shows 325,000 returns became nontaxable for 1971 (out of a total of 63.4 million), 2.8 million returns are nontaxable for 1972 and 1.9 million returns will become nontaxable for 1973 as compared to prior law.

Table 7 presents data, by adjusted gross income class, on the extent to which the standard deduction provisions of the Act induce a shifting of individual income tax returns from itemizing deductions to use of the standard deduction. For 1971 the table indicates a shifting of 1.3 million returns from itemized deduction returns to standard deduction returns; for 1972, a shifting of 3.3 million returns to standard deduction returns; and for 1973, a shifting of 2.2 million returns to standard deduction returns.

Eight additional tables shown in the appendix of this report provide further information as to the impact, by adjusted gross income class, of each of the individual income tax personal exemption and standard deduction changes made by the Act for each of the years 1971–73. In addition, a ninth and a tenth table give the tax burdens under prior law and under the provisions of the Act for 1971–73 for single persons and for married couples with differing numbers of dependents and with selected levels of adjusted gross income under varying assumptions as to deductible nonbusiness expenses.

TABLE 1.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92–178), ON CALENDAR YEAR TAX LIABILITY 1971–73 AND FISCAL YEAR TAX RECEIPTS 1972–74 [1]

[In millions of dollars]

Provision	Calendar year tax liability			Fiscal year tax receipts		
	1971	1972	1973	1972	1973	1974
Liberalizing exemption and standard deduction provisions of the individual income tax:						
Eliminating phaseout from 1971 minimum standard deduction and increasing exemption from $650 to $675	−1,370			−1,370		
Advancing 1973's 15 percent standard deduction and $750 exemption to 1972		−2,190		−855	−1,335	
Increasing the minimum standard deduction to $1,300 for 1972 and thereafter		−1,040	−1,090	−405	−1,105	−1,110
Denying the standard deduction (both minimum and percentage) to the unearned income of taxpayers who are dependent children of other taxpayers		+70	+75	+5	+70	+75
Providing household help, and liberalizing child care, deduction		−145	−150	−15	−145	−150
Providing a tax credit for political contributions		−100	−25	−10	−90	−30
Correcting individual income tax withholding				+725	+75	
Providing tax credit to employers of public assistance recipients under the work incentive program (WIN)		−25	−30	−10	−25	−30
Reinstating investment credit	−1,510	−3,610	−3,910	−2,430	−3,600	−3,970
Eliminating ¾-year convention from the asset depreciation range (ADR) system	+2,100	+1,700	+1,500	+2,470	+1,660	+1,420
Repealing automobile excise tax	−800	−2,200	−1,900	−2,200	−2,000	−1,800
Allowing credit for State tax on coin operated gaming devices		−10	−10		−10	−10
Imposing excise tax (10 cents per pound) on tires of imported automobiles	(2)	+25	+25	+10	+25	+25
Repealing truck (10,000 gross vehicle weight pounds or less) and local transit bus excise tax	−100	−365	−365	−280	−365	−365
Providing tax deferral for domestic international sales corporations (DISC)		−100	−170	(2)	−100	−170
Total	−1,680	−7,990	−6,050	−4,365	−6,945	−6,115

[1] Estimates for all provisions in this table reflect growth except for the provisions relating to excise taxes.
[2] Negligible.

TABLE 2.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), BY TYPE OF TAXPAYER CALENDAR YEAR TAX LIABILITY 1971-73 AND FISCAL YEAR TAX RECEIPTS 1972-74[1]

[In millions of dollars]

Provision	Calendar year tax liability 1971	1972	1973	Fiscal year tax receipts 1972	1973	1974
Liberalizing exemption and standard deduction provisions of the individual income tax:						
Eliminating phaseout from 1971 minimum standard deduction and increasing exemption from $650 to $675	−1,370			−1,370		
Advancing 1973's 15-percent standard deduction and $750 exemption to 1972		−2,190		−855	−1,335	
Increasing the minimum standard deduction to $1,300 for 1972 and thereafter		−1,040	−1,090	−405	−1,105	−1,110
Denying the standard deduction (both minimum and percentage) to the unearned income of taxpayers who are dependent children of other taxpayers		+70	+75	+5	+70	+75
Providing household help, and liberalizing child-care deduction		−145	−150	−15	−145	−150
Providing a tax credit for political contributions		−100	−25	−10	−90	−30
Correcting individual income tax withholding				+725	+75	
Individual, nonbusiness	−1,370	−3,405	−1,190	−1,925	−2,530	−1,215
Providing tax credit to employers of public assistance recipients under the work incentive program (WIN): Corporate		−25	−30	−10	−25	−30
Reinstating investment credit:						
Individual, business	−305	−725	−785	−375	−735	−785
Corporate	−1,205	−2,885	−3,125	−2,055	−2,865	−3,185
Corporate and individual, business	−1,510	−3,610	−3,910	−2,430	−3,600	−3,970
Eliminating ¾ year convention from the asset depreciation range system:						
Individual, business	+420	+340	+300	+450	+340	+290
Corporate	+1,680	+1,360	+1,200	+2,020	+1,320	+1,130
Corporate and individual, business	+2,100	+1,700	+1,500	+2,470	+1,660	+1,420
Repealing automobile excise tax:[2]						
Individual, business	−120	−330	−280	−330	−300	−270
Individual, nonbusiness	−600	−1,650	−1,430	−1,650	−1,500	−1,350
Individual, business and nonbusiness	−720	−1,980	−1,710	−1,980	−1,800	−1,620
Corporate	−80	−220	−190	−220	−200	−180
Corporate and individual	−800	−2,200	−1,900	−2,200	−2,000	−1,800
Allowing credit for State tax on coin-operated gaming devices: Corporate		−10	−10		−10	−10
Imposing excise tax (10 cents per pound) on tires of imported automobiles:[2] Individual, nonbusiness	(3)	+25	+25	+10	+25	+25
Repealing truck (10,000 gross vehicle weight pounds or less) excise tax:[2]						
Individual, business	−40	−165	−165	−120	−165	−165
Individual, nonbusiness	−50	−160	−160	−130	−160	−160
Individual business and nonbusiness	−90	−325	−325	−250	−325	−325
Corporate	−10	−40	−40	−30	−40	−40
Corporate and individual	−100	−365	−365	−280	−365	−365
Providing tax deferral for domestic international sales corporations (DISC): Corporate		−100	−170	(3)	−100	−170
Total:						
Individual, nonbusiness	−2,020	−5,190	−2,755	−3,695	−4,165	−2,700
Individual, business	−45	−880	−930	−375	−860	−930
Individual, business and nonbusiness	−2,065	−6,070	−3,685	−4,070	−5,025	−3,630
Corporate	+385	−1,920	−2,365	−295	−1,920	−2,485
Corporate and individual, business	+340	−2,800	−3,295	−670	−2,780	−3,415
Grand total, corporate and individual	−1,680	−7,990	−6,050	−4,365	−6,945	−6,115

[1] Estimates for all provisions in this table reflect growth except for the provisions relating to excise taxes.
[2] Assumes that the tax changes under these provisions are passed on to the purchasers of the automobiles and trucks.
[3] Negligible.

TABLE 3.—INDIVIDUAL INCOME TAX LIABILITY UNDER PRIOR LAW AND DECREASE (−) OR INCREASE (+) UNDER THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), CALENDAR YEARS 1971-73—BY ADJUSTED GROSS INCOME CLASS

[Dollar amounts in millions]

Adjusted gross income class (thousands)	1971			1972			1973		
	Tax under prior law	Tax change under the Revenue Act of 1971		Tax under prior law	Tax change under the Revenue Act of 1971		Tax under prior law	Tax change under the Revenue Act of 1971	
		Amount[1]	Percent		Amount[2]	Percent		Amount[3]	Percent
$0 to $3	$531	−$55	−10.4	$490	−$181	−36.9	$445	−$133	−29.9
$3 to $5	2,715	−221	−8.1	2,482	−491	−19.8	2,352	−365	−15.5
$5 to $7	4,905	−299	−6.1	4,550	−568	−12.5	4,364	−389	−8.9
$7 to $10	11,222	−208	−1.9	10,721	−698	−6.5	10,228	−215	−2.1
$10 to $15	20,754	−257	−1.2	19,891	−812	−4.1	19,202	−127	−.7
$15 to $20	14,630	−123	−.8	14,158	−364	−2.6	13,891	−97	−.7
$20 to $50	18,912	−89	−.5	18,608	−383	−2.1	18,377	−149	−.8
$50 to $100	7,323	−8	−.1	7,257	−92	−1.3	7,217	−56	−.8
$100 and over	7,696	+7	+.1	7,669	−53	−.7	7,658	−49	−.6
Total	88,687	−1,253	−1.4	85,826	−3,642	−4.2	83,735	−1,580	−1.9

[1] Col. 20, table 4.
[2] Col. 21, table 4.
[3] Col. 22, table 4.

TABLE 4.—ESTIMATED INCREASE (+) OR DECREASE (−) IN INDIVIDUAL INCOME TAX LIABILITY[1] UNDER THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), CALENDAR YEARS 1971-73—BY ADJUSTED GROSS INCOME CLASS

[In millions of dollars]

Adjusted gross income class (thousands)	Liberalization of exemption and/or standard deduction provisions (1971 income levels)			Reinstatement of the investment credit[2] (current income levels)			Elimination of ¾ year convention from the asset depreciation range (ADR) system[2] (current income levels)			Denial of the standard deduction to the unearned income of taxpayers who are dependent children of other taxpayers (current income levels)			Provision of a household help, and liberalization of the child-care, deduction (current income levels)			Provision of a tax credit or a deduction for political contributions			Total		
	1971[3]	1972[4]	1973 and thereafter[5]	1971	1972	1973	1971	1972	1973	1971	1972	1973	1971	1972	1973	1971	1972	1973	1971	1972	1973
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)	(21)	(22)
$0 to $3	−56	−225	−180	−3	−6	−7	+4	+3	+3	......	+48	+52	......	−1	−1	......	([6])	([6])	−55	−181	−133
$3 to $5	−227	−487	−358	−16	−37	−40	+22	+18	+16	......	+19	+20	......	−3	−3	......	−1	([6])	−221	−491	−365
$5 to $7	−310	−526	−339	−27	−66	−71	+38	+31	+27	......	+3	+3	......	−8	−8	......	−2	−1	−299	−568	−389
$7 to $10	−223	−608	−115	−41	−96	−104	+56	+45	+40	......	([6])	([6])	......	−32	−34	......	−7	−2	−208	−698	−215
$10 to $15	−276	−689	....	−51	−122	−132	+70	+57	+50	......	([6])	([6])	......	−37	−39	......	−21	−6	−257	−812	−127
$15 to $20	−135	−267	....	−32	−76	−82	+44	+36	+31	......	([6])	([6])	......	−40	−42	......	−17	−4	−123	−364	−97
$20 to $50	−116	−231	....	−73	−173	−187	+100	+81	+72	......	([6])	([6])	......	−24	−25	......	−36	−9	−89	−383	−149
$50 to $100	−20	−39	....	−33	−78	−85	+45	+36	+32	......	([6])	([6])	......	......	......	......	−11	−3	−8	−92	−56
$100 and over	−5	−11	....	−29	−71	−77	+41	+33	+29	......	([6])	([6])	......	......	......	......	−4	−1	+7	−53	−49
Total	−1,368	−3,083	−992	−305	−725	−785	+420	+340	+300	......	+70	+75	......	−145	−152	......	−99	−26	−1,253	−3,642	−1,580

[1] Exclusive of the impact of the excise tax on automobiles and small trucks on the individual income tax liability of sole proprietors and partners.
[2] Change in tax liability of sole proprietors and partners.
[3] Elimination of the phaseout from the 1971 minimum standard deduction and increasing the exemption from $650 to $675.
[4] Advancement of 1973's 15 percent standard deduction and $750 exemption to 1972 and increase in the minimum standard deduction from $1,000 to $1,300.
[5] Increase in the minimum standard deduction from $1,000 to $1,300.
[6] Less than $500,000.

TABLE 5.—COMPARISON OF THE LIBERALIZED STANDARD DEDUCTION AND PERSONAL EXEMPTION PROVISIONS OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178) WITH THE PROVISIONS OF PRIOR LAW, CALENDAR YEARS 1971, 1972, AND 1973 AND THEREAFTER

Calendar year	Minimum standard deduction		Percentage standard deduction		Personal exemption	
	Prior law	Revenue Act of 1971	Prior law	Revenue Act of 1971	Prior law	Revenue Act of 1971
1971	[1] $1,050 1:15	[2] $1,050	13 percent ($1,500 ceiling)	13 percent ($1,500 ceiling)	$650	$675
1972	1,000	1,300	14 percent ($2,000 ceiling)	15 percent ($2,000 ceiling)	700	750
1973 and thereafter	1,000	1,300	15 percent ($2,000 ceiling)	15 percent ($2,000 ceiling)	750	750

[1] This minimum standard deduction was phased out by reducing the additional allowance (difference between the 1969 minimum standard deduction and $1,050) by $1 for every $15 of adjusted gross income in excess of the 1971 nontaxable level.

[2] The Revenue Act of 1971 eliminated the prior law phaseout.

TABLE 6.—TAXABLE INDIVIDUAL INCOME TAX RETURNS UNDER PRIOR LAW AND NUMBER MADE NONTAXABLE AND NUMBER REMAINING TAXABLE BUT BENEFITING UNDER THE EXEMPTION AND STANDARD DEDUCTION PROVISIONS OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), CALENDAR YEARS 1971-73, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

[In thousands]

Adjusted gross income class (thousands)	1971			1972			1973		
	Returns taxable under prior law	Returns made nontaxable by the provisions	Returns remaining taxable but benefiting from the provisions	Returns taxable under prior law	Returns made nontaxable by the provisions	Returns remaining taxable but benefiting from the provisions	Returns taxable under prior law	Returns made nontaxable by the provisions	Returns remaining taxable but benefiting from the provisions
$0 to $3	5,555	170	5,385	5,531	1,774	3,757	5,257	1,500	3,674
$3 to $5	9,460	95	9,365	9,273	691	8,582	8,947	366	7,404
$5 to $7	9,154	58	9,096	9,069	269	8,800	8,868	68	6,810
$7 to $10	13,316	2	13,314	13,316	44	13,272	13,275		5,132
$10 to $15	15,084		15,084	15,084		15,084	15,084		
$15 to $20	6,334		6,334	6,334		6,334	6,334		
$20 to $50	4,014		4,014	4,014		4,014	4,014		
$50 to $100	398		398	398		398	398		
$100 and over	99		99	99		99	99		
Total	63,415	325	63,088	63,117	2,777	60,340	62,277	1,933	23,021

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

TABLE 7.—TAXABLE INDIVIDUAL INCOME TAX RETURNS WITH STANDARD DEDUCTION AND WITH ITEMIZED DEDUCTIONS UNDER PRIOR LAW AND NUMBER OF RETURNS SWITCHING TO THE STANDARD DEDUCTION UNDER THE STANDARD DEDUCTION PROVISIONS OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), CALENDAR YEARS 1971-73, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

[In thousands]

Adjusted gross income class (thousands)	1971				1972				1973			
	Under prior law			Under the Act	Under prior law			Under the Act	Under prior law			Under the Act
	Total	With itemized deductions	With standard deduction	Returns switching from itemizing deductions to the standard deduction	Total	With itemized deductions	With standard deduction	Returns switching from itemizing deductions to the standard deduction	Total	With itemized deductions	With standard deduction	Returns switching from itemizing deductions to the standard deduction
$0 to $3	5, 555	168	5, 387	20	5, 531	168	5, 362	141	5, 257	169	5, 089	141
$3 to $5	9, 460	1, 821	7, 639	230	9, 273	1, 590	7, 682	577	8, 947	1, 487	7, 460	577
$5 to $7	9, 154	3, 303	5, 851	701	9, 069	2, 696	6, 373	1, 000	8, 868	2, 590	6, 278	1, 000
$7 to $10	13, 316	6, 593	6, 724	317	13, 316	5, 978	7, 338	916	13, 275	5, 503	7, 772	446
$10 to $15	15, 084	9, 739	5, 345		15, 084	8, 165	6, 919	657	15, 084	7, 508	7, 576	
$15 to $20	6, 334	5, 150	1, 184		6, 334	4, 223	2, 111		6, 334	4, 223	2, 111	
$20 to $50	4, 014	3, 684	330		4, 014	3, 395	619		4, 014	3, 396	619	
$50 to $100	398	391	7		398	385	14		398	384	14	
$100 and over	99	98	1		99	98	1		99	98	1	
Total	63, 415	30, 948	32, 467	1, 268	63, 117	26, 697	36, 419	3, 291	62, 277	25, 357	36, 920	2, 164

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

IV. GENERAL EXPLANATION

A. Job Development Investment Credit; Depreciation Revision

1. Restoration of investment credit (sec. 101 of the Act and secs. 49 and 50 of the code)

Prior to 1969, there was a 7-percent investment tax credit (3 percent for public utility property). The Tax Reform Act of 1969 repealed this investment credit for property acquired after April 18, 1969, and for property the construction, reconstruction, or erection of which began after April 18, 1969. In general terms, the investment credit under prior law was available with respect to: (1) tangible personal property; (2) other tangible property (not including buildings and structural components) which was an integral part of manufacturing, production, etc., or which constituted a research or storage facility; and (3) elevators and escalators. New property fully qualified for the credit, but in the case of used property, only an amount up to $50,000 could be taken into account in any one year. In addition, the property had to be depreciable property with a useful life of at least 4 years. Property with a useful life of from 4 to 6 years qualified for the credit to the extent of one-third of its cost. Property with a useful life of 6 to 8 years qualified with respect to two-thirds of its cost, and property with an estimated useful life of 8 years or more qualified for the full amount.

The amount of the investment credit taken in any year could not exceed the first $25,000 of tax liability (as otherwise computed) plus 50 percent of the tax liability in excess of $25,000. Investment credits which because of this limitation could not be used in the current year could be carried back to the 3 prior years and used in those years to the extent permissible within the limitations applicable in those years, and then, to the extent of any amount still remaining, carried forward and used to the extent permissible under the applicable limitations in the succeeding 7 taxable years.

A special rule provided that carryovers to 1969, and subsequent years, could be used in any such year only to the extent of 20 percent of the carryovers. In these cases instead of a 7-year carryover, a 10-year carryover was provided to the extent the credit was limited by the 20-percent factor.

As indicated in the discussion of the reasons for the Act, the Congress concluded that the 7-percent investment credit should be restored as a means of providing stimulus to the lagging domestic economy by reducing the cost of capital to U.S. manufacturers. This will also serve to place them in a more competitive position with foreign manufacturers and in that manner help improve our present serious balance-of-payments situation.

The Act provides for a 7-percent investment credit which is substantially similar to the investment credit previously allowed. The three principal differences from the credit previously allowed are (1) the useful life brackets used in determining the amount of investment in property which is eligible for the credit are to be shortened by 1 year, (2) the credit is generally not to be allowed for foreign-produced machinery and equipment so long as the temporary import surcharge remains in effect [1] (and may be limited after the additional duty is repealed at the discretion of the President), and (3) public utility property is to be eligible for a 4-percent rather than a 3-percent credit.

The credit is to be available with respect to property acquired by the taxpayer after August 15, 1971, or in the case of property which is constructed, reconstructed, or erected by the taxpayer, where the construction is completed after August 15, 1971 (regardless of the time when construction, etc. began). In this latter case, however, the credit is to be available only with respect to that part of the basis of the property properly attributable to construction, etc., after August 15, 1971. The credit also is to be available with respect to property, the construction of which by the taxpayer is begun after March 31, 1971, and property which is acquired after March 31, 1971, and before August 16, 1971, if the taxpayer can clearly establish that the acquisition was made pursuant to an order placed after March 31, 1971. These categories of property which qualify for the credit provided by the Act are referred to in the subsequent discussions as qualifying property (in the Act they are referred to as sec. 50 property). Any property which is pre-termination property and thus eligible for the credit under prior law will continue to be eligible for the credit. (This pre-termination property is included as "section 50 property" in the Act and is included in the term "qualifying property" in this general explanation.)

When the credit was previously in effect the cost of any used property which could be taken into account for purposes of the credit was limited to $50,000 a year. In the case of a husband and wife filing separate returns, the amount of used property which could be taken into account was $25,000, instead of $50,000, unless one of the two had not purchased any used investment credit property, in which case the other spouse could claim the entire amount up to $50,000. The law also contained rules for allocating the $50,000 limitation among component members of a controlled group of corporations and a provision that the $50,000 limit applied at both the partnership and partner levels. Congress believed that the treatment provided for used property when the credit was previously in effect continues to be appropriate. Many small business taxpayers use both new and used property in their operations. In many cases, the circumstances of these taxpayers force them to rely to a significant extent on used property. The Act, therefore, retains the rules which were applicable when the credit was previously in effect insofar as the allowability of the credit for used property is concerned.

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[1] The Act provides that property which is acquired pursuant "to an order placed on or before the date of termination of Proclamation 4074" will be subject to the foreign-produced property limitation. The President terminated Proclamation 4074 on December 20, 1971. The termination of the 10-percent import surcharge had the effect of automatically ending the "buy-American" aspect of the investment credit with respect to foreign-produced property ordered after December 19, 1971. (See item 3 below relating to the limitation of the credit to domestic products.)

2. Determination of qualified investment (sec. 102 of the Act and secs. 46 and 47 of the code)

In order to more realistically reflect the useful lives of property in determining the amount of allowable investment credit, the Act shortens by 1 year the useful life brackets used in determining the portion of investment in property which qualifies for the credit. Under the Act, property with a useful life of 3 to 5 years is to qualify for the credit to the extent of one-third of its cost. Property with a useful life of 5 to 7 years is to qualify for the credit to the extent of two-thirds of its cost, and property with a useful life of 7 years or more is to qualify for the full amount. These replace brackets of 4 to 6 years for a one-third credit, 6 to 8 years for a two-thirds credit, and 8 years and over for a full credit.

In addition, a conforming change is made in the rule of prior law under which there is no recapture of the credit in the case of certain aircraft leased for use outside the United States where this foreign use does not exceed 4 years (i.e., one-half of the 8-year life required for the full amount of the credit). In view of the reduction of the 8-year life requirement to 7 years, the permissible amount of foreign use in the case of these aircraft is reduced to 3½ years. This amendment with respect to leased aircraft used abroad is to apply with respect to leases entered into after April 18, 1969.

The Act provides that a taxpayer must use the same useful life with respect to an asset in determining the amount of the allowable investment credit as the taxpayer uses in computing depreciation or amortization on the asset. This was not necessarily the rule in the past. Where a taxpayer uses a method of depreciation, such as the units-of-production method or the income-forecast method, which does not directly relate the useful life of the property in terms of a specific number of years, the determination as to what constitutes the useful life for purposes of the investment credit as required by the Act should be made by comparing the depreciation taken under the units-of-production method or income-forecast method at the end of 3, 5, and 7 years with the most liberal depreciation which would be taken under the double-declining balance or sum-of-the-years digits method for an asset of the useful life of 7 years. If the depreciation expected to be taken under the units-of-production method or income-forecast method at these time intervals does not exceed by more than 20 percent the depreciation taken under the most favorable of the other two methods, the useful life of the asset under the income-forecast method or units-of-production method will be assumed to be 7 years.

Similar comparisons may be made with other useful lives. If the depreciation actually taken is greater than anticipated, then rules achieving essentially the same result as the recapture rules with respect to the investment credit are to apply. The effect of this is to permit the taxpayer to obtain a tax credit where he utilizes a method of depreciation which yields results substantially equivalent to the double-declining balance or sum-of-the-years digits methods of depreciation for comparable useful lives. This, of course, does not prevent a taxpayer from showing on the basis of his particular facts or circumstances, that other treatment with respect to the investment credit should be made applicable.

The changes made by the Act with respect to the useful life brackets are to apply with respect to qualifying property. In addition, the changes are to apply for purposes of the recapture rules in the case of any property disposed of after August 15, 1971 (and any property which otherwise ceases to qualify with respect to the taxpayer). Thus, in the case of property disposed of after this date with respect to which the full amount of the credit was originally allowed (i.e., because it had a useful life of 8 years or more), there is to be no recapture if the disposition occurs after 7 years of use by the taxpayer.

3. Limitation of credit to domestic products (sec. 103 of the Act and sec. 48(a) of the code)

When the investment credit was previously in effect, it was generally applicable to property which qualified as section 38 property. There were no restrictions placed on the property as to the place where it was manufactured or constructed.

In view of our balance-of-payments difficulties, Congress decided that for a temporary period the credit should be available only with respect to domestically produced property.

The Act provides that the credit is to be denied with respect to foreign-produced property (other than pretermination property) for which a credit is otherwise made available under the Act (i.e., generally, property ordered or the construction of which was begun after March 31, 1971, or property acquired or completed after August 15, 1971). The denial of the credit is to continue under the Act as long as the temporary 10-percent import surcharge remains in effect.[1]

The Act provides two modifications to the above-stated general rule regarding the period for which the denial is to be effective. First, in view of the fact that taxpayers who ordered property (or commenced construction of property) after March 31, 1971, in reliance on the Secretary of the Treasury's statements did so without any knowledge that the credit would be limited to domestically produced property, the Act provides that the investment credit is not denied for foreign property acquired pursuant to an order placed after March 31, 1971, and before August 16, 1971 (or the construction of which by the taxpayer began during this period).

Second, the Congress became concerned that other countries were maintaining nontariff trade restrictions or were engaged in discriminatory acts which substantially burdened or unjustifiably restricted U.S. commerce. The Act provides, therefore, that if on or after the date of the termination of Proclamation 4074, the President determines that a foreign country maintains nontariff trade restrictions, including variable import fees, which substantially burden United States commerce in a manner inconsistent with provisions of trade agreements, or engages in discriminatory or other acts (including tolerance of international cartels) or policies unjustifiably restricting United States commerce, he may by Executive order apply the foreign property provision of the Act to any article or class of articles manufactured or produced in such foreign country for such period as may be provided by Executive order. The trade restrictions and discriminatory acts re-

[1] It should be noted, however, that the President terminated the 10-percent import surcharge effective December 20, 1971. This means that the denial of the investment credit with respect to foreign produced-property as provided under this Act has no applicability after December 19, 1971.

ferred to by this provision are the same as those contained in section 252(b) of the Trade Expansion Act of 1962.

It is expected that the President, in deciding whether a foreign country maintains nontariff restrictions or discriminates unjustifiably against U.S. commerce, will take into account differences in the way similar (or perhaps different) classes of articles are treated by the foreign country in the case of imports from the United States. In the case of motion pictures, for example, it is anticipated that the extent to which foreign-produced motion pictures become eligible for the investment credit (or remain eligible) will be made dependent, to a substantial degree, on whether the foreign country discriminates either against the U.S. motion picture showings in its country, or discriminates in favor of its domestically produced motion pictures.[1]

A termination by the President of the limitation on the credit with respect to foreign property is to apply to property ordered after (or the construction of which is begun after) the termination date specified by the President (either the date of the order or, the exemption can be made retroactive to any date after August 15, 1971, if the President determines it to be in the public interest).

For purposes of this limitation, foreign-produced property includes all property which is completed outside the United States regardless of the U.S. content of the property. In other words, any finished property imported into the United States is to be treated as foreign-produced property even though substantially all of its value is represented by components which were manufactured or produced in the United States. An article is to be deemed completed outside the United States if it enters the country in a form which is operational for the

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[1] American films have been subject to discriminatory practices in many foreign countries. The tax barriers most typically employed are described below:

Screen quotas require theaters to devote a specified proportion of their screen-time to the showing of domestic films. This has the effect of limiting the amount remaining for imported pictures, thus reducing their earning capacity. There are 17 nations which apply such quotas.

Import quotas became widespread after World War II. As the major exporter of motion pictures (American films are estimated to occupy close to 50% of Free World screen-time) the United States was the prime target. While quotas usually are described as designed to conserve foreign exchange, in most instances the primary objective is to protect local film producers from competition of popular American films, with conservation of foreign exchange only a secondary consideration. Most restrictions have now been removed but there are nine Free World countries that still apply quantitative restrictions.

Discriminatory Admission Taxes: Six countries impose higher admission taxes on foreign films than on domestic pictures, either directly or through tax rebates when domestic films are shown.

Film rental price controls, through direct government edict or by indirect pressures impose disadvantageous film rental terms or pernicious conditions on our film sales in 12 countries.

Remittance restrictions following World War II for years posed an extremely difficult problem for the U.S. film industry. Many have been overcome, but they still exist in various degrees in 15 countries.

Local printing decrees necessitate the manufacture of prints for theater use in laboratories of the country to which imported. This is an expensive and inefficient type of restraint which is spreading. Six countries impose such requirements.

Dubbing must be done in local laboratories in three countries. Four others prohibit the dubbing of foreign films into the local language, as a measure to reduce the competitiveness of imported films.

Foreign distributors are barred from having film distribution branches or subsidiaries in seven countries. This type of restriction is designed to force distribution of American films into the hands of local and often inefficient firms.

Exorbitant income or related tax levies are common devices applied against American film companies to drain off their earnings. Six particularly bad situations were noted by the Congress.

Production subsidies, often financed by taxes or other levies on foreign film imports (mainly American), exist in seventeen countries listed herein. They subsidize the cost of local production and thus place films made elsewhere, which receive no such subsidies, at a competitive disadvantage.

Miscellaneous measures include such devices as heavy "dubbing" or "release" fees, compulsory purchase and distribution of domestic pictures, or the establishment of import monopolies.

purposes for which it is intended; minor activities such as packaging or labeling in the United States are not to remove the property from classification as property completed outside the United States. On the other hand, substantial assembly in the United States, such as in the case of aircraft, the installation of the customer's engines, or installation of navigation equipment and completion of the seating and interior arrangements, would be treated as completion in the United States rather than outside the United States.

Foreign-produced property also includes any property completed in the United States, if less than 50 percent of the basis of the property is attributable to value added inside the United States. For this purpose, shipping and insurance costs incurred in transporting property to this country as well as any duty payable upon entry of the property into the United States are to be treated as foreign value. On the other hand, any selling profit as well as any profit attributable to any other U.S. activities in the case of a final product completed in the United States is to be treated as value added in the United States. In addition, components which become part of the property (whether added to the property in the United States or abroad) which originate in the United States and meet either the U.S. value added or completed test are not to be treated as value added outside the United States in applying the 50-percent test.

The buyer, of course, has the normal obligation of establishing for tax purposes that the property qualifies for the credit. It is expected that when there is doubt in the minds of the buyers whether properties qualify for the investment credit because of this provision, they will seek warranties from sellers. Thus, in such cases if the property should prove not to be eligible for the credit because of its foreign content, the seller would recompense the buyer for any loss of the investment credit. This would operate as a result of general contract law, however, rather than as a result of tax law.

To prevent the application of this limitation on the credit in situations where it is appropriate to make the credit available with respect to a type or class of foreign-produced articles because of other overriding considerations, the Act provides the President with authority to waive (by Executive order) the limitation for an article or class of articles, if he determines that it is not in the public interest for the property to be denied the credit. The Congress has clarified the fact that the President may also exercise this authority with respect to an article or class of articles manufactured or produced in a foreign country.

Generally, under the Act, a determination by the President under this authority is to apply to property ordered on or after (or to property the construction of which was begun on or after) the issuance of the Executive order. The Congress does not believe it is appropriate to restrict the President to terminating the limitation on the credit only prospectively, since there may be situations where prior to the date of the issuance of the Executive order it would be in the public interest that the credit not be denied. For this reason, the Act provides that the President may terminate the limitation for periods which are prior to the date of the Executive order and after August 15, 1971, when he finds this is in the public interest.

The types of situations in which the President may find that it is in the public interest to waive the limitation include those: (1) where the U.S. market for a particular type of item tends toward a monopolistic one (i.e., is dominated by one or two domestic producers); (2) where there are practically no U.S. manufacturers of the type of products involved and substantially all items of these types are imported; (3) where the foreign producer of an item can show that it is seeking to develop a market in the United States prior to transferring the manufacturing operations for the item to the United States; and (4) where so-called "free-list" nonduty items which have a long history of free trade (such as farm machinery) are involved.

Congress concluded that it was inappropriate to limit the application of the four exceptions referred to above where there had previously been a significant decrease in the domestic production for the article in question (or substantially similar article). The application of such a rule would be difficult to apply administratively and could result in undesirable consequences with respect to domestic consumers, where, for example, this would perpetuate a situation tending toward monopoly.

4. Definition of section 38 property (sec. 104 of the Act and sec. 48 of the code)

Storage facilities and special purpose structures.—As was the case when the investment credit was previously in effect, buildings and their structural components do not qualify for the credit. However, storage facilities used by the taxpayer in connection with manufacturing, production, extraction, or the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services, are eligible for the credit.

Since the Internal Revenue Service has encountered significant difficulties interpreting this provision, the Congress believed it was desirable to clarify the law regarding the types of storage facilities, and other special purpose facilities, which are entitled to the credit.

The Act specifically provides that property eligible for the investment credit includes a facility, used in connection with any of the activities referred to above (specified in sec. 48(a)(1)(B)(i)) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state).

For a "storage" facility to be eligible for the credit, it must be used principally as a storage facility. Thus, if the facility has a work area in which more than a de minimis amount of processing and handling of the stored commodities can be carried on, it will not be considered to be used principally as a storage facility. If, however, the facility has an area for the housing of equipment directly related to the storage of the commodity, it will not be ineligible for treatment as a qualifying storage facility.

The Act has reference to facilities which are used for the *bulk* storage of *fungible* commodities. Bulk storage has reference to the keeping of a commodity in a large mass prior to its consumption or utilization. The commodity stored must be fungible in nature; that is, of such a nature that one part may be used in place of another.

The term "building" is not intended to include a structure which houses property used as an integral part of a manufacturing or production activity (or other activity referred to in sec. 48(a)(1)(B)(i)) if the use of the structure is so closely related to the use of the equipment it houses that the structure clearly can be expected to be replaced when the property it houses is replaced. Factors which would tend to indicate that a structure is closely related to the use of the equipment include the fact as to whether the structure has been specifically designed to provide for the stress and other demands of the equipment which the structure houses and the fact as to whether the structure could not be economically used for other purposes.

One example of a type of structure closely related to the product it houses which was called to the attention of Congress is a unitary system for raising hogs which includes automatic feed systems, special airflow units, slatted flooring, pens and partitions. The structure which can be added to, according to the number of hogs raised, is no more than a cover and way of tying together the specially designed pens, automatic feed systems, etc. There is no other practical use for the structure and it can, therefore, be expected to be used only so long as the equipment it houses is used. Such a structure would be eligible for an investment credit.

A gasoline storage tank which is placed below the ground is, like a gasoline storage tank located above the ground, to be treated as tangible personal property eligible for the investment credit.

Submarine telephone cables.—As was the case when the investment credit was previously in effect, the Act provides that the investment credit generally is unavailable for property used predominantly outside the United States. In the case of submarine telephone cables, no exception to the general rule was included in prior law.[1]

The maintenance of a satisfactory competitive position by domestic telephone companies furnishing overseas telephone service requires that the investment credit be made available with respect to such companies' interests in submarine cables. This position is also supported by the fact that cables used for such service are generally not employed to furnish telephone service between foreign points; they are generally used only to furnish service between the United States and a foreign point.

The Act, therefore, provides that the credit is to be available for any cable or interest therein of a domestic corporation engaged in furnishing telephone service (of a type described in the definition of public utility property) if it is part of a submarine cable system constituting part of a communication link exclusively between the United States and one or more foreign countries. This provision also is to include any cable or interest therein of a wholly owned domestic subsidiary of such a corporation. No inference is to be drawn, as a result of this Act, as to the treatment of such submarine telephone cable under prior provisions relating to the investment credit.

Coin operated machines in lodging facilities.—As was the case when the credit was previously in effect, property used in connection with the furnishing of lodging is not eligible for the credit, unless the

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[1] The only published position of the Internal Revenue Service (Rev. Rul. 69-2, 1969-1 C.B. 25) concerning the applicability of this limitation to submarine cables held that in the case of a cable extending between the continental United States and Hawaii, since both terminal points of the cable were in the United States, the entire cable was used in the United States and so was eligible for the credit. That ruling did not consider the application of the foreign use limitation in the case of cables extending between the United States and foreign points.

property is a nonlodging commercial facility available to persons not using the lodging facility on the same basis as it is available to persons using the lodging facility. This was interpreted to allow the credit for vending machines, but not for coin-operated laundry machines, in apartment buildings.

Congress concluded that it was not appropriate to draw a distinction between these two types of coin operated equipment. Furthermore, the operation of the laundry machines in the lodging facility might well be in competition with the operation of similar machines in a local laundromat which would be entitled to the credit with respect to its machines. To remove this inequity the Act provided that coin operated washing machines and driers, as well as coin-operated vending machines generally, are to be eligible for the credit (i.e., are not within the exclusion from eligibility provided for property used to furnish lodging or in connection with the furnishing of lodging).

Comsat.—When the credit was previously in effect, property was not eligible for the credit if it was used by an international organization or any agency or instrumentality of such an organization, or if it was used predominantly outside the United States. The application of these rules was unclear in the case of contributions by the Communications Satellite Corporation (Comsat) to the program of the International Telecommunications Satellite Consortium (Intelsat) in orbiting space satellites. Comsat is the United States participant in the Intelsat joint venture formed under 1964 international arrangements to establish a global communications system. Under the 1964 arrangements, the participants in Intelsat own the space segment (primarily satellites) of the satellite system in the form of undivided shares based on their respective contributions to the cost of the space segment. Under recently negotiated arrangements signed by the United States and Comsat on August 20, 1971, Intelsat will itself own the space segment.

Congress believed that exclusion of these communications satellites from the credit would tend to frustrate Congress' purpose in the Communications Satellite Act of 1962 to establish, "in cooperation with other countries, as expeditiously as practicable a commercial communications satellite system" (47 U.S.C. 701(a)). As a result, the Act provides that the use of property by Intelsat is not to disqualify the property from the credit insofar as the portion represented by the interest of Comsat is concerned. In addition, it is provided that communications satellites (as defined in section 103(3) of the Communications Satellite Act of 1962) are not to be disqualified from the credit on the basis that they are used outside the United States.

The communication operations of Comsat are includable within the prior law's term, "telephone services," but no implication is intended that Comsat's property should be so characterized for any other purpose.

Drilling equipment used in international or territorial waters.—Since the inception of the investment credit in 1962 it has been generally provided that property which is used predominantly outside the United States is not eligible for the investment credit. When the credit was previously in effect the law contained an exception for property of a United States person which is used for the purpose of exploring for, developing or transporting resources, from the outer

Continental Shelf. Under the exception a credit would not, however, be available for drilling equipment, rigs, and barges which are used by United States persons in foreign drilling operations (which are off the outer Continental Shelf).

In view of the fact that a substantial amount of offshore drilling activities are, in the years to come, to be taking place in foreign waters and because it is increasingly important to discover and develop natural resource reserves, the Act provides that equipment of this type is to be eligible for the credit.

Under the Act, therefore, the provision dealing with property used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf is expanded to include any property (other than a vessel or an aircraft) of a U.S. person which is used in international or territorial waters for the purpose of exploring for, developing, removing, or transporting natural resources derived from ocean waters or submarine deposits. Certain types of drilling rigs used for these purposes have, under prior rulings, been held to be eligible for the investment credit as documented vessels. No change is intended to be made, as a result of this Act, in the status of such rigs.

Livestock.—In the past the investment credit generally was available for any depreciable tangible personal property subject to the depreciation recapture rules. Prior to 1969, however, the depreciation recapture rules did not apply to livestock. In 1969, livestock was placed in the same position as other types of business property in that it was made subject to the depreciation recapture rules. The Act provides, therefore, that livestock is to be eligible for the credit.

The Act provides two special rules in the case of livestock. First, the Act provides that horses (whether used for racing or other purposes) are not to be treated as property eligible for the credit, since Congress did not believe it was necessary to provide an incentive to investments of this type. Second, in order to prevent taxpayers from creating a tax shelter of artificial credits by disposing of raised livestock, with little or no cost or other basis, and then acquiring substantially similar livestock with the intent of obtaining the credit for the acquired livestock, the Act contains a rule that is analogous to the provisions in present law dealing with wash sales of stock or securities.

Under this provision, if substantially identical livestock has been sold, or otherwise disposed of, by the taxpayer during a one-year period beginning 6 months before he acquires other livestock, the cost on the acquired livestock is to be reduced by the amount realized on the sale of the substantially identical livestock. This rule is not to be applicable, however, if there is an investment credit recapture upon the disposition of the substantially identical livestock. In determining whether the livestock sold is substantially identical to the livestock acquired by the taxpayer, the age of the livestock and use to which the livestock is put are to be considered as significant factors. For example, if a taxpayer disposes of a cow used for breeding purposes and within 6 months acquires another cow of approximately the same age to be used for breeding purposes, the qualified investment attributable to the acquired cow is to be computed by reducing the cost of the acquired cow by the amount realized on the prior sale. If, however, the livestock disposed of is not suitable for continuing use as breeding stock at the time it is sold, it will not be considered substantially identical to livestock which the taxpayer acquires. Similarly, if the taxpayer sells a dairy cow that is, at the time of the sale, no longer suitable for dairy purposes, the taxpayer will not be denied the investment credit for a dairy cow which he acquires to replace the animal sold.

If the livestock disposed of is substantially identical to the livestock acquired by the taxpayer during the one-year period, the cost taken into account in computing the investment credit is to be reduced by the amount realized on the sale. Thus, if the taxpayer sells a portion of a breeding cattle herd for a total of $50,000, and within 3 months acquires other substantially identical breeding cattle for $85,000, the cost with respect to this acquisition will be reduced to $35,000. The earliest sales of substantially identical livestock within the one-year period are to be applied first in reducing cost of an acquisition. Once the amount realized on a sale has been taken into account in reducing the cost of an acquisition, however, it is not to be again taken into account for this purpose with respect to a subsequent acquisition. It is intended that the rule for replacement livestock is not to apply if the replacement is due to an involuntary conversion (including an involuntary conversion on account of disease or drought to the extent provided in section 1033 of the Code).

In determining whether livestock acquired by a taxpayer is new or used property for purposes of the credit, it is intended that livestock be treated in a manner consistent with that provided in the Treasury regulations for other types of property. Property is considered new property for purposes of the credit if its original use commences with the taxpayer. The regulations provide that the term "original use" means the first use to which the property is placed, whether or not the use corresponds to the use of the property by the taxpayer. However, where the property qualifies as a breeding or dairy animal, it will normally be regarded as a new article at the time it is first used for these purposes, that is, at the time its suitability is established by the bearing of a calf or the giving of milk, assuming it has not been used for other purposes prior to that time. On the other hand, if a cow has been used for dairy purposes and later is used for breeding purposes, it will not be "new" property when first used for breeding purposes.

Amortized property.—When the credit was previously in effect, various rules were provided regarding the availability of the credit for property subject to special 5-year amortization. For a limited period of time railroad rolling stock, expenditures for rehabilitating low-income housing, and certain coal mine safety equipment were eligible for a special 5-year amortization provision as well as for the credit. On the other hand, the credit was denied to expenditures for pollution control facilities subject to special 5-year amortization.

These special amortization provisions were enacted as part of the Tax Reform Act of 1969 which also repealed the investment tax credit. Moreover, in large measure these amortization provisions were intended as a substitute for the investment credit then being repealed. In view of the reinstatement of the credit, Congress believed that it was not appropriate to provide both the credit and special 5-year amortization with respect to the same property.

As a result the Act provides that if the taxpayer elects the special 5-year amortization provided for pollution control facilities, railroad rolling stock, coal mine safety equipment, expenditures for the rehabilitation of low-income housing, job training facilities, or day care facilities (the last two categories are new amortization provisions added by this Act), the property subject to the amortization election is not to be eligible for the credit. (If the amortization election is made subsequent to the allowance of the credit, the credit is to be retroactively denied for the year in which it was previously allowed.) Since in the case of pollution control facilities only the proportion of the cost of the facility attributable to the first 15 years of its useful life is eligible for special 5-year amortization, the Act provides that the credit is to be denied only for the portion of the cost of a facility subject to rapid amortization. Therefore, a taxpayer acquiring a pollution control facility may be eligible for the credit with respect to the cost attributable to the useful life in excess of 15 years even though he elects rapid amortization with respect to the property.

Railroad track.—In 1962 the Congress provided that railroad track which is accounted for under the retirement-replacement method of accounting for depreciation was to be eligible for the investment credit, but the Internal Revenue Service never fully effectuated this congressional decision. To clarify congressional intent in this matter, the Act provides that in the case of a railroad (including a railroad switching or terminal company), railroad track replacements (including rail, ties, ballast, other track material and the related installation costs) are to constitute investment credit property if the replacement occurs in one of the following types of situations:

(1) The replacement is made pursuant to a scheduled program for replacement (generally a systematic program covering various segments and locations of a rail system);

(2) The replacement is made pursuant to the detection by a rail-test car of specific rail needing replacement;

(3) The replacement is made pursuant to observations of maintenance-of-way personnel in the field of rail needing replacement: or

(4) The replacement is made as a result of a casualty (such as a wreck, derailment, or other interruption in service).

If the replacement is made as the result of a casualty, the replacement track material is to qualify as investment credit property only to the extent that, in each casualty, the qualified investment with respect to the replacement track material exceeds $50,000. The costs of removing old track material are not to qualify for the credit.

Motion picture and television films.—As previously indicated the investment credit is generally available for depreciable tangible personal property. Questions have arisen, however, whether motion picture and television films are tangible (as distinct from intangible) personal property eligible for the credit. A court case decided the question in favor of the taxpayer. Congress intends that motion picture and TV films be treated as tangible personal property eligible for the investment credit.

In determining the amount of credit available with respect to a motion picture or TV film, it is intended that all costs of production which the taxpayer capitalizes should be taken into account in determining the basis of the film.

Effective dates.—In general, the changes made by this section are to apply only to qualifying property. These changes include those made in the treatment of: storage facilities; coin-operated machines in apartment buildings; property used outside the United States in connection with exploring or extracting natural resource deposits from ocean waters or submarine deposits or the furnishing of telephone service; livestock; property subject to special amortization; and motion picture and television films. With respect to these provisions, no inference is intended as to the proper treatment of these types of property under prior law.

The changes made by the Act regarding the treatment of Comsat and railroad track, however, are intended as clarifying amendments and therefore are to apply to years ending after December 31, 1961. As a result, Comsat will be eligible for the 3-percent credit of prior law and the 4-percent credit provided by this Act (see *5. Regulated companies*, below).

5. Regulated companies (sec. 105 of the Act and secs. 46(c) and (e) of the code)

In general, when the credit was previously in effect, a 3-percent investment credit was provided for public utility property (in contrast to the 7-percent credit given for other property). Public utility property was defined for this purpose as property used predominantly in the trade or business of furnishing or selling (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, (3) telephone service, or (4) domestic telegraph service (if the rates for these services or items were established or approved by certain types of governmental regulatory bodies).

As part of the Revenue Act of 1964 (sec. 203(e) of that Act), Congress provided that, in the case of the investment credit on public utility property (the 3-percent property), no Federal regulatory agency could "flow through" the credit to income more rapidly than ratably over the useful life of the property. In the case of any other regulated company's property (the 7-percent property—chiefly, the interstate gas pipelines), no Federal regulatory agency could flow through to income any part of the credit. In each of these categories, flowthrough was nevertheless permitted if the company consented. Where the company was earning the maximum allowed by law or regulations, this resulted in flowing through the tax reduction to the company's current customers in the form of lower utility rates.

Reasons for provisions.—In restoring the investment credit, the Congress concluded that it was appropriate to increase somewhat the credit previously available for regulated companies. As indicated above, the rate for most public utility property when the credit was previously in effect was 3 percent. The Act raises the rate for public utility property to 4 percent. In part, this is provided because of the increasing problem many utilities are encountering in raising the capital required for modernization and expansion. Additionally, the regulated companies are encountering increased competition from other regulated companies and, in the case of many of their products, from unregulated companies as well. In view of these factors, the Congress concluded that it was appropriate to lessen the difference between the credit allowable for public utilities and for taxpayers generally. In order to equalize the treatment of regulated companies in substantial competition with each other, changes have been made in the categories of regulated property to which the 4-percent credit—as distinct from the 7-percent credit—is to be available. Additionally, the Act limits to 4 percent the credit provided for certain property used in competition with public utility property, even though such property is used by unregulated taxpayers.

To permit all of the benefits of the credit to be flowed through to the consumer currently could have an impact on revenues which is approximately twice that applicable in other cases. Moreover, the basic purpose of the investment credit is not an allocation of resources in order to stimulate consumption of any particular type of product or service. For these reasons, as a general rule, the Act does not make the credit available where all of the benefit from it would be flowed through currently to the consumers. There are a limited number of cases, however, where a regulated company particularly needs to maintain a low rate for consumers, and has under prior laws flowed the benefits of fast depreciation through currently to the consumers. In these cases alone, the Act makes the credit available even though the company elects to flow through the credit currently to the consumers. In all other cases, the credit is made available only where there is assurance that at least some of the benefit will go to the investors.

In restoring the investment credit for public utility property of regulated companies, the Congress gave careful consideration to the impact of this credit on ratemaking decisions. Although there are many different ways of treating the credit for ratemaking purposes, the Congress, in general, believed that it was appropriate to permit the regulatory agencies, where they conclude it is necessary, to divide the benefits of the credit between the customers of the regulated industries and the investors in the regulated industries. The Congress also concluded that where a regulated company furnishes steam through a local distribution system or gas or steam by pipeline, it is appropriate (when the regulatory agency involved determines that the natural domestic supply of the product furnished is insufficient to meet present and future requirements of the domestic economy) to permit the entire benefits of the credit to be used as an incentive to encourage expansion or at least maintenance of the supply.

The Congress believed that this represents the best balancing of the considerations of both investors and customers of the regulated companies, and the extent to which revenue losses may be permitted at this time.

Investment credit rate.—As indicated above, the Act increases the credit for public utility property to 4 percent (i.e., the amount of the qualified investment applicable to this property is raised from three-sevenths to four-sevenths of the cost of the property). The Act also provides that, for the future, property used predominantly in furnishing or selling of all communication services (other than international telegraph services) [1] is to receive the 4-percent credit.[2] Thus, property

[1] This is in addition to the categories indicated above: namely, (1) electrical energy, water, and sewage disposal services, (2) gas through a local distribution system, (3) telephone service, and (4) domestic telegraph service.

[2] Since this change applies only to property eligible for the new investment credit under the bill, this change in the categories of partial-credit property will not, of itself, give rise to an increase in tax under section 47(a)(2).

used in miscellaneous types of regulated communication services, such as data transmission operations, is to receive the 4-percent rather than the 7-percent credit.

The Congress decided, with one limitation, to provide a full credit to international telegraph companies, since it concluded that they are not properly comparable to domestic telegraph companies and other communication companies. They are in active competition with one another, rather than having an exclusive franchise as in the case of the ordinary utility, and they compete with foreign international telegraph companies, substantially all of which are owned or controlled by foreign governments, rather than with the domestic telegraph or telephone industry. The limitation referred to above provides that in the case of submarine cable circuits of a rate-regulated international telegraph company, the investment credit with regard to any circuit between the United States and a point outside the United States is to be limited to so much of the interest of the company in the circuit as does not exceed 50 percent of the total interests in the circuit.

The Congress was impressed by the trend among unregulated businesses to install their own communications equipment rather than equipment made available by the regulated companies.[3] The Congress concluded that, in order to avoid having the renewed investment credit create an improper discrimination in such competition, it was necessary to equalize the rate of investment credit available to the competitors. As a result, the Congress decided to limit to 4 percent the credit for communication property of the type used by regulated telephone and microwave communication companies, if the property is used predominantly for communication purposes. Under present conditions, the Congress intended that this rule (the regulated company rate for competitive communications property of nonregulated companies) is to apply to microwave transmission equipment, private communication equipment (other than land mobile radio equipment for which the operator must obtain a license from the Federal Communications Commission), private switchboard (PBX) equipment, communications terminal equipment connected to telephone networks, data transmission equipment, and communications satellites. This limitation would not apply, for example, to computer terminals or facsimile reproduction equipment which is connected to telephone lines to transmit data. As changes occur in technology and in patterns of regulation, corresponding changes will follow in the applicability of this provision to different types of property.

Treatment of credit in ratemaking.—With regard to the treatment of the credit for ratemaking purposes, the Act provides three basic elective options:

(1) The first option provides that the investment credit is not to be available to a company with respect to any of its public utility property if any part of the credit to which it would otherwise be entitled is flowed through to income; however, in this case the tax benefits derived from the credit may (if the regulatory commission so requires) be used to reduce the rate base, provided this reduction is restored over the useful life of the property.

(2) The second option provides that the investment credit is not to be available to a company with respect to any of its public

[3] A landmark in this field was the *Carterfone* decision of the Federal Communications Commission, 13 F.C.C. 2d 420 (1968).

utility property if the credit to which it would otherwise be entitled is flowed through to income faster than ratably over the useful life of the property; however, in this case there must not be any adjustment to reduce the rate base if the credit is to be available.

(3) Under the third of the elective options, the above restrictions would not apply at all.

All regulated companies are to be allowed to choose between option (1) and option (2) but the choice must be made within 90 days after the date of the enactment of the Act. If no election is made in that time period, option (1) applies.

Option (3) is to be available (as an alternative to option (1) or option (2)) only to a regulated company with respect to property which is "flow-through" property under the accelerated depreciation rules enacted as part of the Tax Reform Act of 1969. Election of this option also must be made within 90 days after the enactment of the Act.

Under the Act, a full-credit regulated company that is subject to the above-described limitations on flow-through and rate base adjustment and that has chosen the first option, may elect to have that option apply so as to forbid any rate base adjustment. This treatment is to apply only if the regulated company elects within 90 days after the date of the enactment of the bill to have it apply, and only if the Federal agency that regulates its rates determines that the natural domestic supply of the product furnished by the company in its regulated business is insufficient to meet the present and future requirements of the domestic economy.

Congress considered a related aspect of the flow-through problem in 1969 with respect to the tax benefits of accelerated depreciation. There, too, it was determined to provide a general rule under which the tax benefits could be shared between investors and customers. An exception was provided in those situations where a company was already flowing through the tax benefits of accelerated depreciation, in order to recognize the special competitive conditions under which such a company was operating and in order to avoid precipitating an increase in utility costs to such a company's customers. Property of these regulated companies (to which sec. 167(l)(2)(C) applies) is eligible for option (3) if an election is made.

Although the depreciation problem is in many respects similar to the matter considered in the Act, it is not identical. Nevertheless, the result of this Act—generally permitting regulatory agencies to share the benefits of the credit between investors and customers where appropriate—is essentially similar to the result of the 1969 depreciation legislation.

The options described above, regarding flow-through and rate base adjustments, are to apply to property which is eligible for the 4-percent credit and also to property eligible for the 7-percent credit which is used for local steam distribution or for gas or steam transportation by pipeline.

In determining the period of time over which the investment credit may be ratably flowed through or over which any rate base adjustment must be amortized, reference is to be made to the period of time on the basis of which depreciation expense is computed on the company's regulated books of account, and not to the useful life used for depreciation under the Internal Revenue Code. A ratable method of flowing through or amortizing is to include a method in which equal amounts are allocated to equal time periods, equal units of production, or machine hours. Composite lives and other averaging methods may be used where appropriate and in accordance with regulations.

In determining whether or to what extent a credit reduces cost of service, i.e., has been flowed through to income, reference is to be made to any accounting treatment that can affect cost of service.[4] One usual method of flowing through the investment credit is to reduce the amount of Federal income tax taken into account. Another method of flowing through the investment credit is to reduce, by the amount of the credit, the depreciable basis of the property on the regulated books of account.

In determining whether or to what extent a credit has been used to reduce the rate base, reference is to be made to any accounting treatment that can affect the company's permitted profit on investment by treating the credit in any way other than as though it had been contributed by the company's common shareholders. For example, if the "cost of capital" rate assigned to the credit is less than that assigned to common shareholders' investment, that would be treated as, in effect, a rate base adjustment.

In the case of the second option (ratable flow-through and no rate base adjustment) the Congress determined to assure that the purpose of the provision is not avoided by flowing through the entire credit to non-operating income (thereby increasing earnings per share even though the regulated company adheres to ratable flow-through in determining cost of service for ratemaking purposes). It might be argued that in this manner the credit could be used to reduce a company's authorized rate of return and thereby achieve an effect similar to that which would occur had the entire credit been currently flowed through to reduce cost of service for ratemaking purposes. To make it clear that this result is not intended, the second option provides that cost of service, as reflected in a company's regulated books of account, may not be reduced by more than a ratable portion of the credit. In such a case, the agency may not require the company to treat the investment credit in its reports to shareholders, or to the public, in any way different from the way the company treats the investment credit for ratemaking purposes.

These rules replace the 1964 Revenue Act rules (sec. 203(e) of that Act), described above.

Prior law (unchanged by the Act in this respect) includes in the definition of public utility property the requirement that the rates for furnishing or selling the enumerated services or products are "established or approved" by a governmental unit. It has been pointed out that in the case of many utilities whose property has been treated as public utility property under prior law, there is no affirmative governmental action in establishing or approving rates. Rather, rates are often established merely by the filing of a tariff with the appropriate regulatory agency, followed by no suspension of the tariff by the agency. In order to prevent dispute as to whether the property of such a company is public utility property, the Congress desired to make it

[4] Although the technical term, "cost of service" includes the cost of common stock investment (that is, the cost of capital rate assigned to such investment, times the amount of such investment), the rule of the first option—permitting a rate base reduction if it is ratably restored—overrides the flat rule prohibiting any reduction of cost of service.

clear that the definition of public utility property includes property of companies whose rates are subject to the jurisdiction of the regulatory agencies referred to in the statute, whether or not the agency generally leaves undisturbed the rates filed by the company.

The Act provides the Secretary or his delegate with authority to deal with those situations under which the literal application of the provisions of these rules does not carry out the purposes of this subsection. This regulatory authority is identical, within its sphere, to the authority granted under the Tax Reform Act of 1969 in the case of the treatment of accelerated depreciation by regulated industries. For example, if a single company operates within the jurisdiction of several regulatory agencies and one of those agencies requires the company to exceed the permitted cost of service or rate base adjustment (see discussion of the various options in such matters, above), then the sanction of the Act (loss of the investment credit) is to apply only to property subject to the jurisdiction of that agency.

Under the Act, if a regulatory agency flows through a company's investment credit at a rate faster than permitted, or insists upon a greater rate base adjustment than is permitted under the applicable option, then that company would not be allowed to take any investment credit for the appropriate period, as described below. The limitations of the applicable option would have to be met in the first final determination put into effect after the date of the enactment of the Act (December 10, 1971), and in every determination (whether or not final) thereafter. In other words, a sanction would not be applied merely because a prior order (for example, one issued in 1968) required excessive flow-through or rate base adjustments. If the first order as to a company after December 10, 1971, is inconsistent with the limitations of the applicable option, it would result in disallowance when the order had been affirmed through the appellate process or the company had let its right of appeal expire, and the order had been put into effect. If the first final order after December 10, 1971, is consistent with the limitations of the applicable option, then the sanction of the Act is not to apply until an order is put into effect which is inconsistent with limitations of the applicable option.

After the first final determination has been issued, the provisions of the Act are to be tested against any determination that affects the rates to be charged by the regulated company or the manner in which the regulated company maintains its books of account.

If an order is inconsistent with limitations of the applicable option, then under the Act all investment credit provided by the Act (i.e., the investment credit for property described in sec. 50) is to be disallowed for taxable years which are open on the date the order is put into effect. Also, the credit will be disallowed as to property placed in service thereafter, until a new order (affecting rates or the regulated books of account) is put into effect, if that new order cures the "inconsistencies" of the previous outstanding orders.

An order is "put into effect," for these purposes, on the later of (1) the date of its issuance (or, in the case of a final order, on the date it becomes final) or (2) the date when it becomes operative. Thus, an order issued on January 1, 1973, requiring a company to make a rate change on July 1, 1973, is put into effect on the latter date. On the other hand, if the January 1, 1973, order requires a rate change retroactive to July 1, 1972, the order is treated as put into effect on January 1, 1973.

The Congress hopes that these sanctions will not have to be imposed. The sanctions are intended to be reasonable in proportion to the duration of the violation of the rules set forth in the Act.

Effective date.—These provisions of the Act regarding regulated companies are to apply to property, including pre-termination property, which qualifies for the new investment credit.

6. Investment credit carryovers and carrybacks (sec. 106 of the Act and sec. 46 of the code)

The amount of the credit previously in effect a taxpayer could claim in a year generally was limited to 50 percent of his liability (the credit could be claimed against 100 percent of tax liability up to $25,000). A 3-year carryback and a 7-year carryforward were provided for credits which could not be used in the current year because of this 50-percent limitation. The 50-percent limitation for a year was applied first against the credits arising in that year and then, to the extent of any remaining limitations, to carryovers of unused credits to that year. When the investment credit was repealed in 1969, an additional limitation was imposed on the use of carryovers of unused credits to reflect the fact that new credits would not generally arise in future years and, thus, in the absence of a limitation, there could be a substantially greater use of unused credit carryovers which would have significantly delayed the impact of the repeal. Generally, it was provided that the amount of unused credit carryovers which could be used in 1969 and later years could not exceed 20 percent of the aggregate amount of carryovers to 1969. In addition, the carryforward period was extended to 10 years for credits which could not be used in a year solely because of this limitation.

In view of the fact that the allowance of a credit for newly acquired property will place a limit on the use of carryovers similar to that provided in prior law, the Act provides that the special 20-percent limitation is not to be applicable with respect to the proportion of the year after August 15, 1971, since taxpayers will currently be generating credits after that date. This is approximately 3/8ths of the calendar year 1971 and therefore the proportion of the carryovers which is not usable in 1971 will be reduced by 5/8ths or from 80 percent to 50 percent. Comparable adjustments were also made with respect to fiscal year taxpayers.

In addition, it was brought to the attention of the Congress that many taxpayers have substantial amounts of investment credit carryovers which arose in the past that the taxpayers would not be able to use either because the carryover period would expire or because credits arising in the future would completely absorb the 50-percent limitation which would prevent the use of carryovers. The Congress was concerned about this situation since the desire of taxpayers to use these credit carryovers as quickly as possible (to avoid losing them) could significantly dampen the stimulative effect of restoring the investment credit because these taxpayers are likely not to make investments while they have carryovers which they might lose. In view of this, the Act provides for a reversal of the application of currently generated credits and carryovers against the 50-percent limitation with respect to carryovers from 1970 and earlier years. It is provided that the 50-percent limitation for 1971 or a later year is to be first absorbed by carryovers from pre-1971 year to that year and then, to the extent of any remaining limitation, by credits arising in that year. Also, the Act provides that carryovers of unused credits from 1970 and earlier years to the extent they have not previously expired are to be allowed a 10-year, rather than a 7-year, carryforward.

The rules discussed above do not apply to carryovers of unused credits from 1971 and later years. Accordingly, in a year after 1971, the 50-percent limitation for the year is to be first absorbed by carryovers from the pre-1971 years, then by the credits generated in that year, and finally by carryovers to that year from 1971 and later years.

The removal of the 20-percent limitation is to apply with respect to the proportion of the year after August 15, 1971. The changes in the order in which credits are to be used is to apply with respect to taxable years beginning after December 31, 1970. The 10-year carryover for unused credits arising before 1971 is to apply to years beginning after December 31, 1970.

7. Treatment of casualties and certain replacements (sec. 107 of the Act and secs. 46(c) and 47(a) of the code)

When the credit was previously in effect, the law provided for the recapture of the investment credit to the extent property was disposed of before the end of the period (that is, 4–6, 6–8, or 8 or more years which the Act changes to 3–5, 5–7, or 7 or more years) which was used in determining the amount of the credit originally allowed. An exception to this recapture rule under the prior credit provided that where the property was stolen or damaged or destroyed by casualty and replaced by property eligible for the investment credit there was no recapture of the credit with respect to the casualty property but, instead, the credit for the replacement property was reduced by a comparable amount. In addition, when the investment credit was repealed in 1969, a transitional rule was added providing that where because of the termination of the investment credit, the taxpayer could not avoid the effects of recapture by acquiring new property (since the investment credit at that time was no longer available), the recapture rules were not to apply.

Congress believed that, since the investment credit was being restored—with the result that replacement property is eligible for the credit—there is no reason to continue any exceptions to the recapture rules. As a result, the Act eliminated the exceptions to the recapture rules for casualties, thefts, and other dispositions. This has the effect of treating casualties and thefts as dispositions and, thus, subjecting all dispositions to the recapture rules.

The repeal of the exception to the recapture rules for property destroyed by casualty or theft applies to casualties occurring after August 15, 1971. In the case of the provision which makes the recapture rules inapplicable where there is a replacement of the property disposed of, the repeal of this provision applies if the replacement property is eligible for the credit under the Act. Thus, where the replacement property is eligible for the restored credit, the property disposed of (which it replaces) is to be subject to the recapture rules.

8. Availability of credit to certain lessors (sec. 108 of the Act and sec. 46(d) of the code)

When the credit was previously in effect, a lessor of investment credit property was entitled to the credit with respect to the property. It also was provided that the lessor could elect, with respect to new property, to pass the credit through to the lessee rather than claim it himself.

The Congress believed that making the credit available to the lessor was desirable, as a general rule, as a way of making the investment credit useful where the taxpayer has little if any tax liability. This is because the benefits of the credit normally are passed on, in large part, to the lessee in the form of reduced prices. Nevertheless, the Congress was concerned about the extent to which individuals (singly or as a group in a joint venture) are able to utilize the tax benefits of leasing transactions (the credit, and the depreciation and interest deductions) as a means to shelter from tax a substantial part of their other income. As a result of the Tax Reform Act, these transactions are less attractive than before because the interest and accelerated depreciation deductions are generally subject to the minimum tax and reduce an individual taxpayer's right to use the 50-percent maximum rate on earned income. Congress was concerned, however, that the restoration of the credit could once again make leasing arrangements motivated largely by tax reasons quite attractive. For this reason Congress believed that it was appropriate to impose limitations on the availability of the investment credit to individual lessors (and other noncorporate lessors).

The Act provides that the credit is to be available to an individual (or other noncorporate) lessor in only two situations. First, if the property which is the subject matter of the lease has been manufactured or produced by the lessor, the lessor is not to be denied the credit. The terms "manufacture" and "production" in this case include the construction or reconstruction of property. Thus, if two individuals are in the business of manufacturing a product and then lease instead of sell the product, they are not to be denied the credit with respect to the product, assuming it otherwise qualifies as investment credit property. In these situations, the lease arrangement is an integral part of the taxpayer's business and is not likely to have been entered into for the purpose of reducing tax liabilities.

Second, the Act provides, in general, for the allowance of the credit in the case of short-term leases since in these cases the leasing activity constitutes a business activity of the taxpayer, rather than a mere investment, i.e., a financing arrangement. However, two conditions must be satisfied for the credit to be available to a noncorporate lessor under this alternative. First, the terms of the lease (taking into account options to renew or extend) must be less than 50 percent of the useful life of the property subject to the lease. The useful life of the property for this purpose is the life used in determining the amount of allowable credit and for depreciation purposes. Second, for the first 12 months after the transfer of the property to the lessee, the sum of the deductions allowable to the lessor with respect to the leased property solely by reason of section 162 (other than rental payments and reimbursed expenses with respect to the property) must exceed 15 percent of the rental income produced by the property during the 12-month period.

The limitations also apply to a lease of property by a partnership or a subchapter S corporation. Thus, unless a lease by a partnership or a subchapter S corporation satisfies either alternative, the credit will not be allowed to the partners or the shareholders of the subchapter S corporation, as the case may be. However, a corporate partner of a partnership is not to be denied its pro rata share of the partnership's credit by reason of this limitation.

A problem may arise when a lessor passes the credit through to the lessee. If the lease term is significantly shorter than the useful life of the property, the amount of the credit passed through to the lessee is disproportionately large. To mitigate this problem, the Act provides limits on the amount of credit that can be passed through to a lessee by a lessor in situations where the property (1) is new section 38 property; (2) has a class life (determined under section 167(m)) in excess of 14 years; (3) is leased for a period which is less than 80 percent of its class life; and (4) is not leased subject to a net lease (within the meaning of section 57(c)(1)). In this type of situation, the Act provides that the lessor is to be allowed to pass through to the initial lessee of the property only that portion of the credit which the period of the lease bears to the class life of the property. The portion of the credit which is not passed through to the lessee will, under this provision, be available to the lessor.

The amendments made by this section of the Act regarding the allowance of the credit to individual lessors are to apply to leases entered into after September 22, 1971. For this purpose, a lease is to be considered entered into prior to that date if there was an enforceable lease agreement in effect prior to that date even though the actual formal lease may not have been executed until after that date. The amendments regarding the pass through of the credit to lessees are to apply to leases entered into after November 8, 1971.

9. Basis adjustment

It was concluded that a basis adjustment mechanism, such as that employed in the past, should not be provided at this time, in view of the concern that the investment credit provided by the Act have as great a stimulative effect on the economy as possible. Generally, a basis adjustment mechanism provides for a reduction in the depreciation base of property for which an investment credit is allowed by the amount of the credit, and it would be necessary to provide a larger credit subject to a basis adjustment to obtain the same overall stimulative effect. The Committee on Ways and Means and the Committee on Finance have requested their staffs and the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation to study and develop a basis adjustment mechanism for consideration within the next two years. It is expected that this study will also review the advisability of retaining the useful life limitations and the limitations based on the taxpayer's tax liability in the present investment credit provisions.

10. Accounting for the investment credit in certain financial reports (sec. 101 of the Act)

The procedures employed in accounting for the investment credit in financial reports to shareholders, creditors, etc., can have a significant effect on reported net income and thus on economic recovery. The Congress was concerned that the investment credit provided by the Act have as great a stimulative effect on the economy as possible.

Therefore, from this standpoint the Congress thought that it would be undesirable to preclude the use of the "flow-through" method of accounting for the investment credit in the financial reporting of net income.

If the investment credit is thought of as decreasing the price of the equipment purchased, it can be argued that reflecting the benefit of the credit in income over the life of the asset is appropriate. However, the investment credit may also be thought of as a selective tax rate reduction applicable in those cases where the desired investments are being made. In this latter event, it is difficult to see why the current "flow through" should be prevented in the financial reporting of income.

In view of these considerations, the Congress believed that it was unwise to require either type of financial reporting but believed that it was desirable that the companies generally indicate in their reports the method they follow in treating the investment credit for financial reporting purposes.

The Act deals with the current accounting treatment for the investment credit in financial reports in certain respects. For purposes of reporting to Federal agencies and for purposes of making financial reports subject to regulation by Federal agencies, the Act permits taxpayers to account for the tax benefit of the investment credit either currently in the year in which the investment credit is taken as a tax reduction, or ratably over the life of the asset. This includes not only reports made to the Federal Government, but also reporting to stockholders to the extent any Federal agency has the authority to specify the method of such reporting. This treatment is to be available notwithstanding any other law or regulation under law. The method used by a taxpayer after the date of the Act must be consistently followed unless permission to make a change in the method of reporting is obtained from the Secretary or his delegate. The Act also requires taxpayers to disclose in these financial reports the method of accounting used for the investment credit. The requirements set forth in this provision are not to apply to reports of regulated public utilities subject to the special rules relating to the treatment of the investment credit for rate making purposes (as provided under section 105 of the Act). This was provided because taxpayers taking the second option—namely, the option of flowing the benefits of the investment credit through in profits over the life of the asset—also are required to account generally in their financial reporting of the credit on the same basis. However, it is expected that regulated companies which do not select this option will have the same rights as taxpayers generally to either flow the benefits of the credit through in profits currently or ratably over the life of the asset as they choose.

11. Reasonable allowance for depreciation; repair allowance (sec. 109 of the Act and secs. 167 and 263 of the code)

Prior actions.—Before 1962, business firms depreciated their property in terms of useful lives that were established for several thousand different classifications of assets (so-called Bulletin "F" lives). The guideline lives for depreciable assets that were put into effect in 1962 consolidated assets into about 75 broad asset classes and also shortened the prescribed lives by up to 30 or 40 percent. The 1962 guidelines also established the use of industry classifications, as distinct from clasifying assets by type of assets.

The lives selected for use under the guidelines were determined by reference to the useful lives claimed by the taxpayers surveyed and generally the lives selected were the useful lives equal to the lives being claimed by the taxpayers at the 30th percentile—that is 29 percent of the assets had shorter lives and 70 percent had longer lives.

The guidelines also contained a reserve ratio test which was designed to assure that taxpayers would not be permitted continually to depreciate their assets over a period of time substantially shorter than the period of actual use. Basically, the reserve ratio test assumes that the actual useful life of assets can be determined by comparing the amount of depreciation reserves to the acquisition costs of the assets being depreciated. Such comparison is known as the reserve ratio. A built-in tolerance was contained in the reserve ratio test to assure that the test would be met in the cases of taxpayers depreciating their assets at a rate not more than 20 percent faster than the period of their actual use of such assets.

The application of the reserve ratio test was initially suspended for three years. In 1965, the reserve ratio test was substantially modified and new transitional rules were added which had the effect of further delaying the application of the test in most cases until about the present time. When the Treasury Department adopted its Asset Depreciation Range System ("ADR") in early 1971, it completely eliminated the reserve ratio test for 1971 and future years.

In addition to removing the reserve ratio test, the ADR system contained the following basic elements:

1. A first-year convention was provided under which taxpayers generally were permitted to take three-fourths of a full year's depreciation for the year in which an asset was placed in service. This was accomplished by allowing a taxpayer to treat all assets placed in service during a year as placed in service on the first day of the second quarter of the year for depreciation purposes. Under the prior conventions, taxpayers generally were allowed to take only a half year's depreciation on assets placed in service during the year.

2. Taxpayers were permitted to vary the period over which they depreciated assets by as much as 20 percent from the guideline lives established in 1962. The assets subject to the ADR system were to be accounted for in so-called "vintage accounts," which included all the eligible depreciable assets placed in service by a taxpayer in a year for which an ADR election was made. A taxpayer electing the system was required to include in his income tax return a schedule showing acquisitions and retirements with respect to each vintage account. The information supplied was to include the type and age of equipment retired. Accordingly, it was anticipated that the Internal Revenue Service would receive regular and complete data with respect to the period of time over which assets were actually used. This type of data, unavailable under prior practice, would permit accurate estimates to be made of the actual use of property on the basis of which useful lives might be projected.

3. The ADR system continued the prior practice of permitting taxpayers to exclude the salvage value of property in determining their annual depreciation deduction, so long as the property was not depreciated below its salvage value. Additionally, ADR provided a tolerance limit within which a taxpayer's estimate of salvage value would not be challenged. Generally, the taxpayer's estimate would not be

challenged if the proposed adjustment was not more than 10 percent of the cost of the property, but if it was more than 10 percent, the entire adjustment including the 10 percent was to be made.

4. Taxpayers were permitted to elect to use a repair allowance to determine the amount of repair expenses and specified repair or improvement expenditures (which might otherwise be treated as capital expenditures) that might be deducted currently. The amount of these items which might be deducted currently was determined by applying the applicable repair percentage prescribed for the guideline class to the cost of the assets in the class. The total amount of these items in excess of the currently deductible amount was required to be capitalized.

5. The depreciation modifications provided in the ADR regulations in the case of certain categories of utilities (such as telephone, electric and gas pipeline companies) was to be available only if they "normalized" the tax deferral obtained thereby for ratemaking purposes. (By "normalize" it is meant that they must for ratemaking purposes show as costs the taxes which would have been incurred in the absence of the provision for shorter useful lives and then gradually reduce these costs as the regular guideline lives would have permitted the depreciation. This treatment with respect to "normalization" is substantially similar to that provided in the Tax Reform Act of 1969 with respect to accelerated depreciation methods.)

6. It was provided that gain on ordinary retirements of assets from a depreciation account was not to be recognized until the reserve for depreciation exceeded the basis of the account and that loss on such retirements was not recognized until the account was closed.

Problems in general.—The three-quarter year convention contained in the ADR system was essentially an incentive to business investment in that it provided an additional allowance in the year property was placed in service. This is, of course, the purpose which is served by the investment credit which the Act makes available. Congress concluded that it was not appropriate to provide this double incentive to business investment and, accordingly, it eliminated the three-quarter year convention.

Congress was also concerned with the fact that after the adoption of ADR there were in effect 3 systems for determining the useful life of property for depreciation purposes: the ADR system, the guideline lives, and the actual life of property to the taxpayer as determined on the basis of his own facts and circumstances. It appeared to Congress that a desirable simplification of the depreciation rules would be achieved if the ADR system and the guideline lives were combined. Accordingly, the Act provides for a class life depreciation system which replaces both ADR and the guideline lives for property placed in service after 1970. In general, under the class life system, the Treasury Department is given authority to prescribe class lives based on anticipated industry norms (or norms based on other classes) and to permit taxpayers to elect the application of the system. If they elect to use the system, the Internal Revenue Service may permit depreciation lives within a range of 20 percent above or below the class life. Congress recognized that many of the elements contained in the ADR system (including the repeal of the reserve ratio test) were designed to achieve significant simplifications in the administration of the depreciation rules by substantially limiting the number of situations in which disputes were likely to arise based on the particular facts and circumstances of the individual taxpayer's situation. It is contemplated that these elements of the ADR system will be incorporated by the Treasury into the class life system provided by the Act.

Provision for class lives.—The Act provides a unified system of class lives which may be elected by taxpayers for assets placed in service after 1970. A taxpayer which elects to determine the useful life of assets it acquires during a taxable year under this class life system generally must use the system for all assets acquired during the year which fall within any class for which the Treasury has established a class life. As discussed more fully below, the Act allows taxpayers during a transition period of not more than 3 years to exclude from the class life system certain real property and subsidiary assets.

The Treasury may permit taxpayers to use a useful life for one or more classes of property which varies from the class life by up to 20 percent. (In determining the limitation of this variance, lives may be rounded to the nearest half year.)

In prescribing the lives of property within a specified class, the Treasury is to determine a life which reasonably reflects the anticipated useful life of the class of property in question to the industry (in the case of an industry or sub-industry classification) or other group (in the case of an asset or other type of classification). Initially, it is intended that the new class lives will be the same as those prescribed by the 1962 guideline lives. As the Treasury Department collects and analyzes data regarding the useful life of property to taxpayers, it may adjust the class life it has prescribed in order to reflect in general the actual asset replacement practices of taxpayers in the 30th percentile. As previously indicated, this was in general the basis on which the guideline lives were established.

Under the class life system, the Treasury also may redefine or subdivide the classes of property both in order to provide a more reasonable classification for depreciation purposes and also as is required for the effective functioning of the new system. For example, a separate class could be established for used property and for foreign property.

An election by a taxpayer to use the class life system is to be subject to the conditions prescribed by the Treasury Department. In general, it is contemplated that conditions substantially similar to those provided in the ADR system will be prescribed by the Treasury with respect to the class life system. Thus, a taxpayer will be required to elect the use of the class life system for a taxable year by the time the return for that year is required to be filed. A taxpayer who does not make an election during this period of time may not avail himself of any class or guideline life but rather must demonstrate the actual anticipated useful life of each of its assets (or asset accounts). An election to come under the system for a taxable year may not be changed or revoked once it is made. A taxpayer which elects the class life system may, with respect to property leased by it, depreciate the property on the basis of the appropriate class life (without regard to the period of the lease).

In addition, it is intended that a taxpayer who elects the class life system be required to use vintage accounts as in ADR and to provide to the Treasury the type of information required under the ADR system. Other elements of the ADR system which it is contemplated will be incorporated in the class life system include the treatment of salvage value (both the provision that salvage value does not affect the rate of depreciation, but rather limits the total amount of depreciation which may be claimed, and also the tolerance limits within which adjustments to a taxpayer's estimates of salvage value will not be challenged), the treatment of public utilities, and the treatment of retirements, under which generally the recognition of gain or loss on ordinary retirements is postponed. The treatment of retirements in this manner, of course, is not to affect the application of the investment credit recapture rules when property is disposed of.

Congress recognized that under the rules of the 1962 guidelines taxpayers in many cases were permitted to depreciate real property over shorter lives than the guideline lives because of the particular facts of the taxpayer's situation. If these taxpayers were, as a condition of electing the class life system, required to include their real property in the election, they would be substantially adversely affected since they would have to use significantly longer lives for the real property than they had used in the past. In view of this, Congress believed it appropriate to provide a transitional rule for these taxpayers to enable them to make use of the class life system while the Treasury Department studies the general matter of the appropriate lives for real property. Accordingly, the Act provides that, in the case of real property placed in service during the 3-year period beginning on January 1, 1971, taxpayers who elect the class life system may exclude from the election real property in cases where for the first year a life shorter than the initially prescribed class life (which is to be the 1962 guideline life) is justified for the asset under the rules of the 1962 guidelines. If the Treasury Department subsequently prescribes class lives for real property prior to the end of the 3-year period, it is provided that this transition rule is to terminate with respect to property placed in service after the date on which any such class life becomes effective with respect to it.

Under the 1962 guidelines, subsidiary assets (such as jigs, dies, textile mill cam assemblies, returnable containers, glassware and silverware) had a depreciation class separate from that provided for other major items of equipment in the respective industry. A separate class was provided for these subsidiary assets because in some cases their useful lives were substantially shorter than other assets used in the industry. Instead of providing specific guideline lives in these cases, the taxpayer used the life appropriate to the facts and circumstances of his situation. Under the ADR system, however, subsidiary assets were not provided a separate class, but, rather, were grouped in a class with other major assets in the industry, which class had in some cases a substantially longer life. The Treasury Department has been studying the lives of these assets with a view to developing either a separate class with a shorter life for them or to making any appropriate modifications in the life of the class in which they presently are included. During the transition period while this study is being made, Congress believed it appropriate to allow taxpayers to exclude subsidiary assets from the class life system in those cases where the subsidiary assets constitute a significant portion of a class of assets prescribed under the class life system. For this purpose subsidiary assets acquired by a taxpayer during a year will be considered to constitute a significant portion of the total acquisitions of property within the class during the year if the unadjusted basis of the subsidiary assets is at least 3 percent of the aggregate unadjusted basis of the total assets acquired within the class during the year. Subsidiary assets excluded from the class life system under this provision are to be depreciated or expensed in the manner which is appropriate to the facts and circumstances of the individual taxpayer. This transition rule is to apply to subsidiary assets placed in service during the period beginning on January 1, 1971, and ending on December 31, 1973 (or on such earlier date on which a class is prescribed by the Treasury Department which consists of or includes subsidiary assets).

First year convention.—As indicated above, the Act eliminates the three-quarter year convention provided under the ADR system. It does this by providing that no first-year convention is to be allowed for depreciation purposes if the convention would generally allow a greater amount of depreciation for the year assets are placed in service than the depreciation which would be allowable if it were computed without regard to any convention. In applying this test to determine whether a convention is permissible, the convention is to be applied on the assumption that all assets were acquired ratably throughout the year. Thus, for example, a convention which for depreciation purposes treats all property placed in service during the first half of the year as placed in service at the beginning of the year and property placed in service during the second half of the year as placed in service at the end of the year would be permissible. Similarly, a convention which treats all property placed in service during a year as placed in service at the mid-point of the year for depreciation purposes would be permissible.

Repairs allowance.—The Act also provides that the Treasury Department may, by regulations, provide for the treatment of repairs. To provide a means of resolving the disputes which frequently arise as to whether an item constitutes a deductible repair expense or a nondeductible capital expenditure, it is provided that the Treasury may prescribe repair allowances for classes of depreciable property which reasonably reflect the anticipated repair experience with respect to the class of property in the industry or other group. The repair allowances are to be developed and modified by the Treasury on the basis of data regarding the repair experience of the industry or other group with respect to the class of property. Initially, it is expected that the repair allowances prescribed by Rev. Proc. 71–25 will be used. It is expected that the Treasury will have the same authority to provide classes for this purpose as with the class life system of depreciation.

A taxpayer permitted to elect the use of the repair allowance will be allowed to deduct, up to the amount of the repair allowance for the class of property, the aggregate of the amounts incurred by the taxpayer as repair expenses and as specified expenditures (ordinarily chargeable to capital account) for the repair, maintenance, rehabilitation, or improvement of the class of property.

If the amounts incurred by the taxpayer for these purposes exceed the repair allowance, then the excess is to be capitalized. This excess may qualify for the investment credit. It is not intended, however, that expenditures which are clearly of a capital nature, such as those which substantially increase the productivity or capacity of an existing identifiable unit of property or those which modify an existing identifiable piece of property to make it usable for a substantially different use, are to be treated as deductible expenses under this provision rather than as capital expenditures. In other words, these latter types of expenditures are in all events to be capitalized and not taken into account under the repair allowance provision.

The Act clarifies the relationship of the repair allowance provided by the Act to the repair allowance rule contained in pre-existing law with respect to railroad rolling stock other than locomotives (sec. 263(e)). Under pre-existing law, the rehabilitation of this railroad rolling stock is treated as an expense in those cases where the cost involved in a 12-month period does not exceed 20 percent of the unadjusted basis of the unit involved. The Internal Revenue Service in proposed regulations took the position that the application of this rule was mandatory whenever railroad rolling stock was repaired. Since Congress intended this provision to be available at the election of the taxpayer, the Act clarifies the fact that this rule is elective. In addition, the Act provides that with respect to railroad rolling stock (other than locomotives) a taxpayer may elect either the repair allowance rule of pre-existing law or the repair allowance rule provided by the Act, but not both. A taxpayer which elects the repair allowance rule of pre-existing law with respect to railroad rolling stock (other than locomotives) may elect the repair allowance rule provided by the Act with respect to other classes of assets.

Effective dates.—The class life depreciation system provided by the Act is to be applicable with respect to property placed in service by the taxpayer after December 31, 1970. In situations where a taxpayer's return for a taxable year which includes January 1, 1971, has been filed prior to, or shortly after, the enactment of the Act, it is intended that the Treasury Department will allow a reasonable period of time after the enactment of the Act for the taxpayer to elect the application of the class life system (whether or not the taxpayer elected the application of the ADR system for that year).

Although the class life system is not applicable with respect to assets placed in service prior to January 1, 1971, the Treasury Department may provide an elective guideline life system for such assets similar to the class life system.

The repair allowance provision contained in the Act applies to taxable years ending after December 31, 1970. The clarification of the fact that the railroad rolling stock repair allowance rule is elective applies with respect to taxable years beginning after 1969.

Real property.—The Ways and Means Committee and the Finance Committee concluded that in connection with the Treasury Department's review of the useful lives of tangible personal property, it would also be desirable that there be a study of the lives accorded various types of real property. Therefore, the committees requested the Treasury Department to undertake such a review. In this connection the committees agreed that it was also desirable for the Treasury to consider whether, if lives are shortened, the recapture rules presently applicable in the case of real property should be made more like those applicable to personal property.

12. Revenue effect

It is estimated that the elimination of the three-quarter year depreciation convention will increase tax liabilities by $2.1 billion in calendar year 1971, $1.7 billion in calendar year 1972 and $1.5 billion in calendar year 1973. The restoration of the investment credit is estimated to decrease tax liabilities by $1.5 billion in calendar year 1971, $3.6 billion in calendar year 1972, and $3.9 billion in calendar year 1973.

B. Individual Income Tax Reductions

1. Individual income tax relief for 1971 (secs. 201, 203 and 205 of the Act and secs. 151, 141, and 21 of the code)

Under prior law, the amount of the personal exemption was $650 for calendar year 1971. The amount of the low-income allowance was $1,050 for 1971, but a portion of the low-income allowance was reduced or "phased out" by $1 for every $15 of the taxpayer's income in excess of the tax-free income levels.

The Act increased the personal exemption to $675 for 1971 and removed the "phaseout" on the low-income allowance, making it a flat $1,050, to provide tax relief to lower income taxpayers for 1971. The 1971 tax reductions for illustrative taxpayers are shown in Tables 9 and 10 in the Statistical Appendix. These reductions also offset to some extent the underwithholding for 1971 created by the prior withholding system (discussed below under "Withholding changes"), and thus eased the burdens faced by taxpayers when the balance of their 1971 tax was paid. For fiscal year taxpayers, the applicable personal exemption and standard deduction are determined by a proration rule which takes into account the number of days in the taxable year falling in each calendar year.

The tax reduction from the higher personal exemption is estimated to be $925 million for 1971 and the tax reduction from the removal of the phaseout of the low-income allowance is estimated to be $443 million, a total of $1,368 million. These reductions and the number of taxpayers affected are shown by income class in Tables 1, 2 and 3 in the statistical appendix.

2. Individual income tax reductions for 1972 and later years (secs. 201, 202, 203, and 205 of the Act and secs. 141, 151, and 21 of the code)

Increase in the personal exemption.—Under prior law, the amount of the personal exemption was scheduled to increase to $700 for 1972 and to $750 for 1973 and later years. The increased amounts applied to the personal exemptions available to taxpayers, their spouses and dependents, as well as to the additional exemptions available in the case of blindness and for a taxpayer age 65 or over. The $700 and $750 also applied to the amount of gross income a dependent of a taxpayer may receive and still permit the taxpayer to claim an exemption for the dependent (other than a dependent who is under age 19 or a student to whom no income limit applies).

The Congress believed that as part of the program to stimulate the economy, the increase in the personal exemption scheduled for 1973 should be moved up to 1972. The acceleration of the 1973 exemption increase to 1972 was expected to provide immediate economic stimulus by making additional funds available to consumers. Moreover, the tax relief this provided to lower- and middle-income taxpayers was accomplished without creating any long-term revenue loss as compared to prior law.

The Act increased the amount of the personal exemption (and the gross income limit in the case of a dependent) to $750 for 1972 and subsequent years. The tax reduction for illustrative taxpayers from the higher personal exemption, changes in the low-income allowance and in the percentage standard deduction (discussed below) are shown in Tables 9 and 10 in the Statistical Appendix.

The tax decrease from the higher personal exemption is estimated to be $1.9 billion for 1972. It does not, however, result in any additional revenue loss for 1973 and subsequent years over that which would have resulted from the provisions of prior law.

Increase in the low-income allowance and the percentage standard deduction.—Under prior law, for 1972 and thereafter, the low-income allowance was scheduled to be $1,000 with no "phaseout." The percentage standard deduction under prior law for 1971 was 13 percent of adjusted gross income with a $1,500 ceiling and was scheduled to increase to 14 percent with a $2,000 ceiling for 1972 and to 15 percent with a $2,000 ceiling for 1973 and subsequent years. (Married taxpayers filing separate returns were limited to one-half these dollar amounts.)

The low-income allowance (or minimum standard deduction) was designed so that in conjunction with the personal exemption, it would free persons with incomes below the estimated "poverty level" from income tax. Because rising prices have increased the poverty level, the $1,000 low-income allowance in combination with the $750 personal exemption provides a tax-free income level which is significantly below the poverty level. This can be seen in Table 7 below which shows the estimated poverty level for 1972 for different size families as compared to the tax-free income level provided by the $1,000 low-income allowance and the $750 personal exemption. For example, the poverty level for a single person is estimated to be $2.170 in 1972 compared to the tax-free level of $1,750 which would be provided for that year by the $750 personal exemption and the $1,000 low-income allowance. For a married couple, the 1972 poverty level is approximately $2,800 compared to the $2,500 tax-free level available with the $750 personal exemption and $1,000 low-income allowance for that year under prior law.

To bring the tax-free income levels up to the 1972 poverty level in almost all cases, and also to provide tax relief to lower income persons above the poverty levels, the Congress concluded that the low-income allowance should be increased to $1,300. As shown in Table 7 below, the tax-free income level provided by the Act for a single person in 1972 will be $2,050 (compared to the estimated poverty level of approximately $2.170). For a married couple with no dependents, the tax-free level will be $2,800 (compared to the poverty level of approximately $2,800); and for a family of four, the tax-free level of $4.300 available with the $1.300 low-income allowance is almost exactly equal to the estimated poverty level for 1972 of $4,290.

TABLE 7.—POVERTY INCOME LEVELS AND TAX-FREE INCOME LEVELS UNDER 2 LOW-INCOME ALLOWANCE LEVELS BY FAMILY SIZE

Number in the family	Estimated 1972 poverty level	Tax-free income level with $750 exemption and— $1,000 allowance	$1,300 allowance
1	$2,170	$1,750	$2,050
2	2,810	2,500	2,800
3	3,350	3,250	3,550
4	4,290	4,000	4,300
5	5,050	4,750	5,050
6	5,680	5,500	5,800

The increase in the low-income allowance provided by the Act also generates more economic stimulus per dollar of individual income tax reduction than would other forms of tax relief. This is because the tax reduction resulting from the low-income allowance goes to those at the lower income levels who are likely to spend virtually all of it.

In addition to increasing the personal exemption and the low-income allowance for 1972, the Congress concluded that it was desirable to accelerate to 1972 the other remaining change scheduled for 1973; namely, the increase in the percentage standard deduction from 14 to 15 percent. This provides additional tax relief to low- and middle-income taxpayers and also provides additional simplification for 1972 by causing a substantial number of taxpayers to switch from itemizing their deductions to claiming the standard deduction.

For 1972 and thereafter, the Act provides a low-income allowance of $1,300 and a percentage standard deduction of 15 percent of adjusted gross income with a $2,000 ceiling. (Married taxpayers filing separate returns are entitled to a low-income allowance of $650 each or a maximum percentage standard deduction of $1,000 each.) The increase in the low-income allowance to $1,300 will provide tax reductions for 25 million returns, relieving 1.9 million from tax. Filers of 2.2 million returns are expected to switch from itemizing their deductions to the standard deduction. The tax reduction for illustrative taxpayers in 1972 and 1973 from the $750 personal exemption, the $1,300 low-income allowance, and the 15 percent standard deduction is shown in Tables 9 and 10 in the Statistical Appendix. For fiscal year taxpayers, the applicable personal exemption and standard deduction are determined by a proration rule which takes into account the number of days in the taxable year falling in each calendar year.

The increase in the low-income allowance to $1,300 is estimated to provide a tax reduction of $1,040 million for 1972 and larger amounts thereafter compared to prior law. The combined tax reduction for 1972 from the $1,300 low-income allowance, the increase in the amount of the personal exemption to $750, and the increase in the percentage standard deduction from 14 to 15 percent is estimated to be $3,230 million ($2,190 million of which is due to acceleration of the increases scheduled for 1973 under prior law and, therefore, occurs in 1972 only). These reductions and the number of taxpayers affected are shown by income class at calendar year 1971 income levels in Tables 4 through 8 in the Statistical Appendix.

3. Filing requirements (sec. 204 of the Act and sec. 6012(a) of the code)

Under prior law, the income level at which a tax return must be filed was designed to correspond to the tax-free income levels. The level for 1971 and 1972 was $1,700 for a single taxpayer and $2,300 for a married couple under age 65 (or a single person age 65 or over), $2,900 for a married couple where only one spouse is age 65 or over, and $3,500 where both spouses are age 65 or over. For 1973 and threafter, these income levels were scheduled to be further increased to $1,750, $2,500, $3,250 and $4,000, respectively, to reflect the scheduled increase of the personal exemption to $750 in that year.

Since the increase in the low-income allowance to $1,300 was not taken into account in the filing requirement levels provided under prior law, the tax-free income level for 1972 would be $300 higher than the filing requirement levels which otherwise were applicable in that year. Consequently, the Act raised those levels to avoid the filing of returns by individuals whose income is below the taxable level.

For 1972 and thereafter, the Act increased the income level at which a tax return must be filed by $300 above the level previously provided for 1973. Accordingly, the filing requirement is $2,050 for a single person, $2,800 for a married couple (or a single person age 65 or over), $3,550 for a married couple where one spouse is age 65 or over, and $4,300 for a married couple when both spouses are age 65 or over.

In addition, the Act changed the filing requirement from the $1,750 of prior law to $750 for taxpayers who receive unearned income and are dependents of other taxpayers because they may be taxable on their income in excess of the $750 personal exemption amount. The provision for dependents with unearned income (contained in section 301 of the Act) is explained in "C. Structural Improvements" below.

4. Waiver of penalty for underpayment of 1971 estimated income tax (sec. 207 of the Act and sec. 6654 of the code)

Under prior law, individuals were required to pay estimated income tax if they expected more than $200 of nonwage income generally or if they expected a gross income of more than $5,000 in the case of a single person, or $10,000 in the case of a married couple, and if they expected their final tax payment to be $40 or more. If such a taxpayer's estimated tax payments (including taxes withheld) were less than 80 percent of the tax due (as shown on his return), a 6-percent penalty is imposed on the amount of the underpayment (which is the difference between the tax paid and 80 percent of the tax due).

Because of the underwithholding problems created by the Tax Reform Act of 1969, many taxpayers who had not previously paid estimated tax might find that they have an unexpected balance due at the time of filing their 1971 returns (this is discussed below in "Withholding changes") which is substantial enough to cause the imposition of the 6-percent underpayment penalty. The Congress concluded that since much of this underwithholding was unexpected and was caused by the withholding system which these taxpayers generally rely on, it would be unfair to impose the additional tax penalty on this underwithholding.

The Act provided that the penalty for underpayment of estimated income tax for individuals was not to apply for 1971 in the case of certain calendar year taxpayers. Generally, those taxpayers for whom the penalty was waived were single persons (or married persons not entitled to file a joint return) whose gross income did not exceed $10,000, married individuals entitled to file a joint return if their combined income was less than $20,000, and heads of households and surviving spouses if their gross income did not exceed $20,000. The waiver did not apply, however, if the taxpayer had more than $200 ($400 in the case of married taxpayers entitled to file a joint return) in income from sources other than wages.

The waiver of penalty applied to the taxable year beginning after December 31, 1970, and ending before January 1, 1972.

5. Withholding changes (sec. 208 of the Act and sec. 3402 of the code)

Prior law provided a percentage withholding method for 1971, 1972, and 1973, which incorporated the personal exemption, the low-income allowance and the percentage standard deduction provided by prior law for those years. Wage bracket withholding tables based on the percentage method were prescribed by the Secretary of the Treasury.

Because of the increase in the low-income allowance to $1,300 for 1972 and the acceleration of the increases in the personal exemption and the percentage standard deduction scheduled for 1973 to 1972 provided by the Act, it was necessary to change the withholding rates to reflect these changes. In addition, the prior withholding structure did not withhold a sufficient amount in many instances. The principal sources of this underwithholding were: (1) the incorporation of the low-income allowance into the withholding structure resulted in a married couple receiving two low-income allowances for withholding purposes when both spouses work, whereas they were entitled to only one on their tax return (the same problem also occurred where a person worked for more than one employer at the same time); (2) the $2,000 ceiling on the percentage standard deduction was not reflected in the withholding rates so that a taxpayer whose standard deduction was limited by the ceiling had too little tax withheld; and (3) the top withholding rates were not high enough. The Congress concluded that it was desirable to correct these sources of underwithholding by adopting a new withholding system.

The Act provides new withholding rates which reflect the $750 personal exemption, the $1,300 low-income allowance and the 15-percent standard deduction. In addition, the Act changes the withholding structure to eliminate the underwithholding caused by the low-income allowance.

The new withholding structure provided by the Act has a bottom bracket of $550 to which a zero rate applies in place of the $1,000 bracket of prior law. A single person with only one employer or a married taxpayer if his spouse is not employed is able to have the full $1,300 low-income allowance taken into account for withholding purposes by claiming, on the withholding certificate (W-4) filed with his employer, a "standard deduction allowance," which is referred to as a "special withholding allowance" on the withholding certificate. The $1,300 minimum standard deduction is taken into account since the amount of the "standard deduction allowance" is $750 and this plus the bottom bracket of $550 to which a zero rate applies totals $1,300.

A married taxpayer is not allowed to claim an extra $750 "standard deduction allowance" if his spouse is also an employee receiving wages subject to withholding. In that case, the taxpayer and his spouse each have the bottom withholding bracket amount of $550 exempt from withholding, a total of $1,100. This is $200 less than the $1,300 low-income allowance and would tend to create overwithholding. This tendency, however, is partly or wholly offset by the fact that when two earners combine their income on the tax return, it is generally subject to higher tax rates than the withholding rates applicable to the separate earnings of each spouse. In addition, a taxpayer is not allowed to claim the "standard deduction allowance" if he has withholding exemption certificates in effect with more than one employer.

Another source of underwithholding which is corrected is the practice of taxpayers claiming withholding exemptions with more than one employer at the same time. The result of this is, in effect, to allow exemptions twice. For example, a single individual who claims a $750 exemption with each of two employers can have as much as $1,500 exempt from withholding on account of exemptions even though he is entitled to only one $750 exemption on his tax return. The Act deals with this source of underwithholding by instructing an employee not to claim the same withholding exemptions with more than one employer at a time.

To correct the underwithholding caused by the lack of a standard deduction dollar limit and the inadequate top withholding rates, the withholding change, in effect, incorporates the $2,000 ceiling on the percentage standard deduction by increasing the appropriate withholding rates. In addition, a seventh withholding bracket is added and the withholding rates generally are adjusted upward. These changes will result in withholding the full amount of tax liability up to a wage level of approximately $25,000 for a single person and $31,000 for a married couple (with only one spouse working) compared to the level of about $13,500 in each instance under present law. (These levels assume the standard deduction.)

The Congress concluded that it was not practical to make the withholding changes applicable to wages paid after December 31, 1971, since it takes several weeks after the Act is passed by the Congress for the Internal Revenue Service to produce the new withholding tables and new (form W–4) withholding certificates and provide the material to employers. Additional time also was required for employers to incorporate the new withholding changes into their payroll operations, particularly giving their employees the opportunity to file new withholding certificates and explaining the use of the new certificates to them. Consequently, the Act provided that the withholding changes apply to wages paid and withholding certificates filed after January 15, 1972.

The changes in the withholding structure to correct underwithholding are estimated to increase tax withheld by $2 billion in calendar year 1972, assuming most employees file new withholding certificates (W–4). To the extent that taxpayers use the provision for excess itemized deductions (discussed below) or reduce their voluntary overwithholding correspondingly, the $2 billion could be reduced or eliminated entirely. To the extent that employees do not file new withholding certificates with the correct number of special withholding allowances and personal exemptions, the increase in withholding will be larger than $2 billion.

In conjunction with the withholding changes, the provision of prior law which permitted a taxpayer with large itemized deductions to avoid overwithholding is changed by permitting an additional withholding allowance for each $750 of itemized deductions in excess of 15 percent of estimated wages or $2,000, whichever is less. The $2,000 was added by the Act because the $2,000 standard deduction limit was incorporated into the withholding rates. This provision is also liberalized to make it easier to use. Under prior law, a taxpayer's estimate of his itemized deductions for the current year generally could not exceed the deductions claimed on his tax return for the preceding taxable year or, if he had not yet filed his tax return for the preceding year, the second preceding year. After April 30 of the current year, or after he had filed his tax return for the preceding year, however, the estimated deductions could not exceed those of the preceding year. If a taxpayer wishes to reduce his withholding under this provision, it is preferable for him to take advantage of the provision at the beginning of the year. The above rule may, however, have required him to file a second exemption certificate during the year.

The Congress concluded that this rule was unnecessarily restrictive and was likely to deter taxpayers from making use of the provision. Consequently, the Act provided that a taxpayer who has not yet filed his return for the preceding year must base his estimate of his deductions (other than his "determinable additional deductions") on the amount of deductions claimed for the second preceding year but need not file a new exemption certificate after filing his return, even if the itemized deductions for the preceding year are less than those of the second preceding year.

In addition, the Act provided that the additional allowances are to remain in effect until the taxpayer files a new withholding exemption certificate with his employer because of a change in circumstances (which the employee is required to do). Under prior law, the additional allowances were not effective after April 30 of the following year.

6. Declaration of estimated tax (sec. 209 of the Act and sec. 6015(a) of the code)

Under prior law, individuals were required to file a declaration of estimated tax and pay the tax in installments if they expected their tax not covered by withholding to be $40 or more and either expected to have income from sources other than wages of more than $200 or expected their gross income to exceed certain amounts. These amounts were $5,000 for a single person or a married person not entitled to file a joint return and $10,000 for a married couple entitled to file a joint return, a head of household and a surviving spouse.

The withholding system of prior law provides sufficient withholding to match tax liability in most cases at income levels substantially above the income levels at which a declaration may be required under prior law. In addition, the higher withholding rates provided by the Act for 1972 and thereafter (discussed above in "Withholding changes") increase the income levels at which withholding will match tax liability. Consequently, Congress concluded that it is appropriate to raise the income levels above which a declaration is required to conform to the new withholding structure. In addition, the $40 of final tax payment requirement should be raised, since this amount no longer presents the same difficulty for the taxpayer or the Internal Revenue Service as it once did. For similar reasons, Congress believed that the $200 of income from sources other than wages (which implies approximately a $40 tax in the lower brackets) also should be updated.

The Act increases the income level at which a declaration must be filed to $20,000 for a single person, a head of household and a surviving spouse, and a married individual whose spouse does not receive wages. The income level remains at the $10,000 amount of prior law in the case of a married couple where both spouses receive wages because the withholding system does not match withholding and tax liability at as high a level in the case of two earners. A declaration is also required if gross income is expected to include more than $500 of income from sources other than wages. No declaration of estimated tax is required, however, if the estimated final payment is expected to be less than $100.

These higher declaration levels are effective for tax years beginning after December 31, 1971.

7. *Deduction for household service and dependent care expenses (sec. 210 of the Act and sec. 214 of the code)*

Under prior law, certain categories of taxpayers were granted limited itemized income tax deductions for amounts they spent for the care of a dependent child and also generally incapacitated dependents where these expenditures enabled the taxpayer to be gainfully employed. Thus, it was recognized that an adult responsible for the care of small children might incur child care expenses to earn a livelihood and that these expenses, therefore, can be viewed as to some extent like an employee's business expenses. In general terms, this deduction for child care expenses has been available either where there was only one employable parent in the family or where the combined earnings of the husband and wife were no greater than the median family income level in the United States. The median income level at the time this provision was revised in 1964 was approximately $6,000. Married couples with incomes below this amount were included under this provision because it was recognized that in these cases the earnings of both the mother and the father were essential to the maintenance of minimum living standards and that, in such situations, the requirement for providing child care could be just as pressing as in the case of a family with only one adult.

The categories of taxpayers eligible for child and incapacitated dependent care deduction under prior law were:

1. Working wives where the adjusted gross income of the husband and wife did not exceed $6,000 and a joint return was filed (the deduction in this case was phased out on a dollar-for-dollar basis for income above $6,000),

2. Working wives whose husbands were incapable of work because they were physically or mentally incapacitated,

3. Widows and working women (other than wives) with children or incapacitated dependents,

4. Widowers, and
5. Husbands whose wives were incapacitated or institutionalized (if the wife was incapacitated but not institutionalized the $6,000 limit referred to above applied).

A deduction in the types of cases referred to above was allowed for the expenses for the care of a dependent child (under age 13) and also for expenses for the care of other dependents unable to care for themselves because they were physically or mentally incompetent. Under prior law, the maximum deduction for child (or incapacitated dependent) care expenses was $600 in the case of one dependent and $900 in the case of two or more dependents.

The Congress concluded that this provision needed substantial revision for several reasons.

First, it believed that families with one working adult (whether male or female) or families with two adults where both are employed substantially full time and there is a child (or incapacitated dependent) in the home, need help not only with respect to child (and incapacitated dependent) care expenses but also for household help they must obtain in order to be gainfully employed. The domestic help is needed in these cases because the adult members of the family are employed full time and in this sense the domestic help expenses can to some extent be likened to an employee business expense. At the same time, the Congress believed that it is desirable to provide employment opportunities for persons presently having difficulty in this respect. Still a further reason for encouraging expenses for household help in the case of an incapacitated dependent (or spouse) is that the Congress believed that, to the extent possible, it is desirable to make provisions for the care of incapacitated dependents in the home rather than in institutions outside of the home.

Second, the level of child care deductions permitted under prior law was wholly inadequate. Six hundred dollars in the case of one child or $900 in the case of two or more children in many cases does not cover the cost of child care (or the cost of caring for an incapacitated dependent in the home). In addition, since Congress intended this provision to provide not only for child care but also for domestic help, it is also appropriate for this reason to increase the level of the maximum allowable deduction substantially.

Third, the Congress believed that the income level above which this deduction was not allowable in the case of a husband and wife under prior law was much too low. Since 1964 median family incomes have risen from about $6,000 to nearly $10,000 in 1970 and it is anticipated that the levels will be appreciably higher than this in 1972. Moreover, the Congress concluded that tax relief in this respect was desirable not only for families with below-average incomes, but also for those with middle incomes as well. The Congress, on this basis, concluded that the combined family income level, below which the household service and dependent care expense deductions are fully available, should be raised to $18,000.

Fourth, under prior law the child care deduction phased out, in the case of married taxpayers (unless the husband was incapacitated or the wife was institutionalized) above a combined family income level of $6,000 on the basis of a one dollar reduction in the allowable expense deduction for every dollar of income of the family above $6,000. The effect of this was to eliminate the child care deduction quite abruptly. The Congress believed that it is more appropriate to reduce the allowable deduction by 50 cents for every dollar of income of the family above the $18,000 level. In view of the substantial increase in the income level below which the deduction is fully available, the Congress concluded that it is appropriate to eliminate the prior law distinction between single and married taxpayers and reduce the amount of the allowable deduction by $.50 per dollar of income in excess of $18,000 for single and married taxpayers alike. For the same reason, the phaseout now applies to married taxpayers where one spouse is disabled or institutionalized. Thus, for example, a taxpayer with income of $19,000 and with allowable expenses of $1,000 would still be able to deduct $500 of those expenses.

For the reasons indicated above, the Congress included in the Act a provision substantially revising and extending the prior child and incapacitated dependent care deduction. As under prior law, the deduction is available only if the taxpayer itemizes his deductions. The deduction is made available to any taxpayer who maintains (furnishes over half the cost of) a household which contains a dependent of the taxpayer under age 15 for whom the taxpayer can claim a personal exemption, or who is the taxpayer's dependent (or spouse) who is physically or mentally incapable of caring for himself. In the case of married taxpayers, the deduction generally is available only if they file a joint return. This deduction is available both for household service expenses and also for dependent care expenses, if the expenses are incurred in order to permit the taxpayer to be gainfully employed. Household service expenses for this purpose include employment in and about the home whether or not these expenses are limited to care of the children; they include caretaker services as well as employment in the home. They do not, however, include amounts paid to an individual for such services as those of a gardener, bartender or chauffeur.

The Congress decided that in the case of domestic or dependent care services provided in the home, a deduction for expenses incurred of up to $400 a month should be allowed. In addition, however, the Congress recognized that in the case of child care, the child is often taken to a day care center or to another person's home for care during the day. As a result, a deduction is permitted for child care expenses outside of the home up to $200 a month for the care of 1 child, $300 a month for the care of 2 children, or $400 a month for the care of 3 or more children. Such expenses outside of the home cannot, however, include educational expenses incurred for a child in the first or higher grade level since the availability of public schools means these expenses are not necessary for the taxpayer to be gainfully employed. In any case, the total deduction for child care outside the home plus domestic or dependent care expenses for services provided in the home cannot exceed $400 a month. (Only expenses not in excess of $400 incurred during a month can be taken into account. Thus, for example, if a taxpayer incurred expenses of $500 in one month and $300 in another month, he could take into account only $700 of expenses, not $800, regardless of when they were paid.)

The payments for household service or dependent care in order to be deductible cannot be made to a person who is related to the taxpayer to such an extent that such a person could be claimed as a dependent whether or not the individual had as his principal place of abode the home of the taxpayer (the relationships specified in secs. 152(a)(1) through (8)). These relationships are generally a son or daughter or descendant thereof; a stepson or stepdaughter; a brother, sister, stepbrother or stepsister; the father or mother or an ancestor of either; a stepfather or stepmother; a nephew or niece; an uncle or aunt or one who bears an in-law relationship to any of the above. Nor are the payments deductible if they are made to a dependent of the taxpayer (as specified in sec. 152(a)(9)) who, even though not having any of the above relationships to the taxpayer, is a member of the taxpayer's household. This prohibition does not apply to persons hired to provide care or household services who would not otherwise be in the taxpayer's household such as, for example, "live-in" maids.

The deduction with respect to child care is available for children who may be claimed as dependents of the taxpayer and are age 14 and under. In addition, the dependent care deduction is available for a dependent of the taxpayer who is mentally or physically disabled to the extent that he is unable to care for himself.[1] For this purpose, a person may qualify as a dependent who is not a dependent only because he has earnings in excess of $750.

The household service or dependent care deduction is available to families where there is a child or other qualified dependent where the taxpayer is single, a widow or widower, divorced, legally separated, or where the individual is married but is living apart from his or her spouse and files a separate return. (Where a married couple is not treated as single under sec. 143(b), the deduction is available only if they file a joint return.)

The deduction for household service or dependent care is available in the case of married individuals with respect to any month in which both the husband and wife are employed on a full-time basis or one spouse is disabled and the other is gainfully employed. For the purpose of this provision, the term "employed on a full-time basis" means employed for three-quarters or more of the normal or customary work week (or the equivalent on the average during a month).

Finally, the deduction is phased out for all taxpayers with income levels above $18,000 on the basis of a reduction of 50 cents in the deduction otherwise allowable for each dollar of the adjusted gross income of the taxpayer (or the combined income of the couple on a joint return) above the $18,000 dollar limit.

For purposes of the reduction for adjusted gross income in excess of $18,000, expenses incurred during any month are to be compared to the adjusted gross income properly allocable to such period. Thus, if a taxpayer incurred $400 of expenses in December 1972 and his income

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[1] In determining deductible expenses in the case of a disabled dependent (other than a dependent child under age 15) the dependent care expenses incurred are reduced by the dependent's adjusted gross income for the year and any nontaxable disability payments (government or private) he receives in excess of $750. In the case of a disabled spouse, the expenses are reduced only by the amount of the disability payments. The reason for this treatment is that the dependent could presumably pay the expenses for his own care to the extent of any such income. As a result, to this extent, no deduction for the taxpayer is necessary. The expenses reduced in this way are only those solely attributable to the disability of the dependent (such as the care provided by a nurse) and do not include household service expenses (such as those provided by a maid). In these cases, the income taken into account is applied first against expenses attributable to the disability which are in excess of the $400-a-month limit. Then any of this income remaining is applied against the expenses coming within the $400-a-month limit. The reduction for the taxpayer's adjusted gross income in excess of $18,000 is applied after these rules.

for 1972 was $20,000, no deduction would be allowed even if he actually paid these expenses in 1973 and his income for that year was $10,000. Generally, the period for this purpose will be the taxable year, but allocations to shorter periods (such as a month) may be necessary where there is, for example, a change in marital status. In the case of individuals whose marital status changes during the year, the availability of the deduction is determined with regard to the eligible expenses incurred and the income earned by each spouse during the period of each marital status in a manner similar to present regulations.

This provision is effective with respect to taxable years beginning after December 31, 1971.

It is estimated that this provision will result in a decrease in tax liability of $145 million for calendar year 1972.

C. Structural Improvements

1. Unearned income of taxpayers who are dependents of other taxpayers (sec. 301 of the Act and sec. 141 of the code)

Under prior law, the standard deduction and the deduction for a personal exemption were available to a taxpayer regardless of the source of his income. This enabled taxpayers to use the minimum standard deduction as a means of reducing the tax on income generated by property transferred by gift. If a person transfers property outright, or to a trust, for a dependent (usually a minor), the income from the property is not taxed to the grantor or to the recipient to the extent of his personal exemption and minimum standard deduction. The increases in the standard deduction (and in the personal exemption) under prior law enhanced the desirability of diverting income in this manner from the high tax bracket of a donor with substantial income to a minor with little or no other income.

Congress believes that the essential abuse in this area is the allowance of two standard deductions (that allowed to the parent and that allowed to the child) for unearned income of a family unit. This abuse is present whether the child's unearned income arises from property transferred in trust or from property transferred outright. On the other hand, although questions can be raised conceptually as to whether an additional personal exemption should be allowed in such a case, Congress believed that practically a child should be allowed the personal exemption to prevent the necessity of the child filing a return where he has only a few dollars of unearned income.

As a result, the Act provides that in the case of a taxpayer who is claimed as a dependent of another, the standard deduction will not be available for use against unearned income. The Act provides that the low-income allowance may not exceed earned income (as defined in sec. 911(b)) and that the percentage standard deduction will be computed only with reference to the taxpayer's adjusted gross income which is attributable to earned income. For example, if a child (who is eligible to be claimed as a dependent) has earned income of $600 and unearned income of $1,400 in 1972, he is not entitled to a standard deduction in excess of $600. This will result in taxable income of $650 ($2,000 gross income less a $750 personal exemption and a standard deduction of $600). In the absence of this provision, the taxpayer would have no taxable income, since he would be entitled to a personal exemption of $750 and a minimum standard deduction of $1,300. If, in 1972, a taxpayer, to whom this section applies, has $2,000 earned income and $15,000 dividend income, the percentage standard deduction would be limited to 15 percent of $2,000, rather than 15 percent of $17,000. This provision will have its application in situations where the dependent is a child who is under 19 or who is a student, since there is no limit on the amount of gross income the child may receive in these situations and still be claimed as a dependent by his parent.

The limitation applies to a taxpayer with respect to whom another taxpayer was entitled to a dependency exemption during the year, whether or not the taxpayer was in fact claimed as a dependent by that other taxpayer. Any individual whose standard deduction is reduced by this provision is not to be eligible to use the optional tax tables for individuals (since the standard deduction is built into these tables). If the taxpayer's return shows an adjusted gross income of less than $10,000, and he is not entitled to use the optional tax tables for individuals as a result of the application of this provision, the standard deduction, after the application of this provision, is to be allowed if the taxpayer so elects on his return.

This provision is to be applicable to taxable years beginning after 1971.

2. Limitation on carryovers of unused credits and capital losses (sec. 302 of the Act and sec. 383 of the code)

Under the tax laws, there are special limitations on net operating loss carryovers when the ownership of a corporation changes either because of a purchase or because of a reorganization. The code provides (sec. 382(a)) in general that if 10 or fewer persons acquire more than 50 percent of the stock of a corporation by purchase within a 2-year period, the net operating loss carryover is eliminated if the corporation does not continue to carry on a trade or business substantially the same as that conducted before the change in stock ownership. In addition, if a corporation which has a net operating loss carryover (a "loss corporation") is acquired by another corporation in a tax-free reorganization, the net operating loss carryover is reduced unless the shareholders of the loss corporation receive at least 20 percent of the stock of the acquiring corporation (as measured immediately after the acquisition). In such a case, the percentage of the loss carryover which is allowed is five times the percentage interest acquired by the shareholders of the loss corporation

These limitations, however, did not apply to carryovers of unused investment credits, unused work incentive program credits, excess foreign tax credits, or capital losses. Thus, the tax benefits of these carryovers could have been purchased or acquired by the acquisition of a corporation having these types of carryovers. Congress believed that there is no greater justification for allowing the acquisition of these benefits than there is in the case of net operating loss carryovers.

Accordingly, the Act provided that the limitations of present law which apply to carryovers of net operating losses in situations where a loss corporation is acquired also are to apply (in the manner provided under regulations prescribed by the Secretary or his delegate) to situations involving carryovers of unused investment credits, unused work incentive program credits, excess foreign tax credits, and capital losses of the acquired corporation.

This provision is to apply with respect to reorganizations and other changes in ownership occurring after December 10, 1971, pursuant to a plan of reorganization or contract entered into on or after September 29, 1971.

3. Amortization of certain expenditures for on-the-job training and child care facilities (sec. 303 of the Act and sec. 188 of the code)

Present law provides a deduction for depreciation of tangible property (except land) used in a trade or business or held for the production of income. Under this provision, tangible property acquired by an employer in his business as an on-the-job training facility or as a child care facility for his employees is depreciable in the case of new personal property (i.e., machinery and equipment) on the basis of the double-declining balance method and in the case of new real property (i.e., buildings and structures) on the basis of the 150-percent declining balance method of depreciation.

Prior to April 18, 1969, the taxpayer could also claim the 7-percent investment tax credit for new depreciable tangible personal property (and to the extent of $50,000 for used property). Under this Act, the investment credit can again be claimed for tangible personal property. The credit, however, is not generally available for depreciable real property.

Congress concluded that there is a need for job training programs as a means of providing additional employment opportunities for persons with inadequate training. Other provisions of the Act are designed to improve the operation of the Work Incentive Program which has as its goal the preparation of welfare recipients for jobs and their placement in jobs.

Congress also recognized that expansion of the availability of child care is an essential element in broadening job opportunities for mothers. Another provision of the Act would provide a substantial deduction for child care and other household expenses needed to enable a mother to work.

But there is also a great need for making child care facilities available if we are to provide an opportuntiy to work to mothers who desire to do so. Though there has been some increase in recent years in the number of child care facilities supported in part with public funds, the Congress believed it desirable to go beyond this by encouraging private business to provide child care facilities for their own employees.

A study issued by the Women's Bureau of the Department of Labor ("Day Care Services: Industry's Involvement," Bulletin 296, 1971) surveyed the extent to which employers have established child care centers for working mothers. To 1971, only a small number of companies were involved directly and a few others indirectly.

Similarly, the Congress believed that it is also important to encourage private business to provide facilities for on-the-job training programs. On-the-job training experience is believed to be the most effective and productive type of training for many jobs, as the person gains actual work experience during the training. Moreover, the person is more likely to complete the training if a job is available at the end of the training.

To meet the needs described above, the Act adds a new provision to the tax law providing that a taxpayer may elect, in accordance with regulations prescribed by the Secretary or his delegate, to amortize ratably over a period of 60 months capital expenditures in acquiring, constructing, reconstructing or rehabilitating on-the-job training or child care facilities. The amortization is to begin with the month the property is placed in service and the deduction provided is to be in place of any depreciation deduction otherwise allowable. The Act defines eligible property as depreciable tangible property which qualifies under regulations as an on-the-job training facility for employees (or prospective employees) of the taxpayer or as a child care facility primarily for children of the taxpayer's employees.

It is the intent of Congress that the five-year amortization be applicable only to facilities or portions of facilities that are constructed, renovated or remodeled specifically for use as child care facilities. The provision thus applies to buildings and equipment, or portions of them, actually used for the provision of child care services; that is, facilities in which children receive such personal care, protection and supervision in the absence of their parents as may be required to meet their needs.

Thus, the provision includes a room or rooms, or play equipment and materials particularly suited to the needs of children being cared for during the day. But the provision does not apply to general purpose rooms used for many purposes (for example, a room used as an employee recreation center during the evening) nor does it apply to a room or a part of a room which is simply screened off for use by children during the day. Such special facilities as kitchen facilities connected to the child care center or area, or special children's toilet facilities could be included within the provision of the Act.

An on-the-job training facility must be one whose primary purpose is as a location for providing training. Thus, a production facility could not be classified as an on-the-job training facility simply because new employees receive training on the machines they will be using as fully productive employees.

Property eligible under the provision does not include property located outside the United States. In addition, the amortization is available only with respect to qualified expenditures made after December 31, 1971, and before January 1, 1977. This latter provision will give Congress an opportunity to review the effectiveness of the provision after it has been in effect for five years.

The Act amends the code to provide that gain realized on the disposition of property eligible for amortization under this provision is to be subject to the recapture rules (of sec. 1245) to the extent of the amortization deductions taken under this provision. The Act also amends present law (sec. 57) to provide that the amount by which the amortization deductions exceed depreciation deductions otherwise allowable (including, for this purpose, accelerated depreciation deductions) is to be treated as a tax preference for purposes of the minimum tax. This is consistent with the policy Congress has generally followed with respect to amortization deductions. The Act also makes necessary conforming amendments (to secs. 642 and 1082) to provide for the treatment of amortization deductions in the cases of estates and trusts, and exchanges made in obedience to Securities and Exchange Commission orders.

An amendment (to sec. 48) also provides that if an election is made under this provision, the property involved is not to be treated as property eligible for the investment credit.

The amendments of the Act dealing with the amortization of expenditures for on-the-job training and child care facilities are applicable to taxable years ending after December 31, 1971.

4. Excess investment interest (sec. 304 of the Act and secs. 57 and 163 of the code)

For taxable years which began before 1972, "excess investment interest" was a tax preference item subject to the minimum tax on tax preferences in the case of individuals (and subchapter S corporations and personal holding companies). For taxable years beginning after 1971, excess investment interest of individuals, instead of being subject to the 10-percent minimum tax, is subjected to a limitation as to the extent to which it is currently deductible. This limitation on the deduction of excess investment interest, in general, provides that only one-half the amount of this type of interest in excess of $25,000 may be deducted currently.

In general, "excess investment interest" is the amount of interest paid by the taxpayer with respect to property held for investment reduced by the net amount of investment income derived by the taxpayer from property of this type.

Property subject to a net lease is considered to be property held for investment for these purposes. One of the tests provided in present law for determining whether a lease is a net lease for this purpose looks to the degree of the lessor's business activity with respect to the leased property. This test provides that a lease is a net lease if the trade or business deductions arising with respect to the property are less than 15 percent of the rental income produced by the property.

Various problems which were raised regarding the provisions of the tax law relating to investment interest were dealt with in the Act. First, the Act provides that a lessor's deductions for rents with respect to leased property are not to be taken into account as business deductions for purposes of the 15-percent test which is used to determine whether the lease constitutes a net lease. This provision is designed to deal with the situation where a lessor pays ground rents with respect to the leased property. Since these rents do not provide a measure of the lessor's business activities with respect to the leased property, it was considered inappropriate to allow these items to be taken into account in determining whether the 15-percent test was satisfied.

Second, the Act provides that business expenses of a lessor which are reimbursed by the lessee can not be taken into account for purposes of the 15-percent test. Since the lessor generally does not incur any risks with respect to the reimbursed expenses in this case, it was not considered appropriate to take these expenses into account as an indicator of whether the lease constituted a business rather than an investment lease. Of course, to the extent a lessor is at risk with respect to reimbursed expenses, this is a factor to be taken into account in determining whether the expenses may be applied toward satisfaction of the 15-percent test.

A third problem called to Congress' attention involved the application of the 15-percent net lease test in situations where the taxpayer is the lessor of a parcel of real property which is composed of a number of units each of which is subject to a separate lease, such as in the case of a shopping center or office building. It was suggested that the application of the 15-percent test poses difficult administrative and allocation problems in this type of situation, since the lessor must allocate the various expenses he incurs with respect to the parcel of property to each specific lease to determine whether the 15-percent test is satisfied with respect to that lease. Congress believed that it was desirable to provide taxpayers with a means of avoiding this administrative allocation problem.

As a result, the Act provides that a taxpayer who is the lessor of a parcel of real property which is subject to two or more leases may elect to aggregate all the leases in a parcel and treat these leases as a single lease for purposes of determining whether in the aggregate the real property is subject to a net lease under the 15-percent test, or is to be considered business property. It is intended for purposes of this provision that leases on adjacent properties are to be included in the term "parcel of real property."

A fourth problem brought to Congress' attention involves the application of the 15-percent net lease test in a year occurring after the property has been leased for a period of time. If the taxpayer is still suffering losses after that time, it is likely they are true economic losses. The potential for creating tax losses from the combination of interest and depreciation, to be applied against other investment income, will have largely disappeared by that time.

Accordingly, the Act provides that taxpayers may elect to exclude from the application of the 15-percent test all leases of real property which are more than 5 years old. The election is to be made on a year-by-year basis. If a taxpayer makes this election, then, with respect to the year for which the election is made, no lease of real property of the taxpayer is to be treated as a net lease by virtue of the 15-percent test for any period after the property has been in use for five years. As a result, any interest paid with respect to this leased property is not to be considered investment interest and any income arising with respect to the leased property is not to be considered investment income.

The fifth problem pointed out was concerned with the fact that the treatment of excess investment interest did not take account of situations in which the taxpayer incurred an out-of-pocket loss on leased investment property. In other words, in these cases there was no reduction in the amount of excess investment interest treated as a tax preference (or subject to disallowance in the case of taxable years after 1971) in situations where the taxpayer's out-of-pocket expenses (i.e., expenses for business and investment expenses, interest, and property taxes) on investment property leased by the taxpayer exceeded the rents derived from that property for the year. Congress believed that it was inappropriate to deny an interest deduction with respect to these out-of-pocket losses. As a result, Congress added an amendment to provide that the amount of excess investment interest as otherwise determined is to be reduced by the amount of the taxpayer's out-of-pocket losses on leased property. The out-of-pocket loss in this case is the excess of the deduction for trade or business or investment expenses, interest, and property taxes (secs. 162, 163, 164(a)(1) or (2) and 212) over the gross rents from the property. This rule will apply, however, only where the construction of the property has been completed and rents are actually being received from tenants.

The changes in the net lease provision are to apply in the case of the minimum tax on tax preferences to taxable years beginning after December 31, 1969 (the effective date of that tax), and in the case of the limitations on the current deduction of excess investment interest to taxable years beginning after December 31, 1971 (the effective date of that provision).

5. Farm losses of subchapter S corporations (sec. 305 of the Act and sec. 1251(b) of the code)

Under present law, farm net losses previously used by a taxpayer to offset nonfarm income are recaptured (upon the sale or other disposition of certain farm property) to the extent these losses are required to be added to the taxpayer's "excess deductions account." This account—referred to as the EDA account—provides a way of keeping a record of farm losses which are to convert subsequently realized farm capital gains into ordinary income. However, additions to this account need to be made only in a year in which an individual's nonfarm adjusted gross income is in excess of $50,000 and a farm loss is to be taken into account only to the extent it exceeds $25,000. Although no such limits are available in the case of most corporations, they do apply in the case of a subchapter S corporation (since its income is taxed to the shareholders rather than to the corporation). However, even for a subchapter S corporation, the limits do not apply in any year in which any one of its shareholders has a net farm loss for the taxable year involved.

Two potential problems in the application of the present farm loss provisions to subchapter S corporations were brought to the Congress' attention. First, it was suggested that a subchapter S corporation with more than $25,000 in farm net losses for a taxable year (but with nonfarm income of $50,000 or less) would not be required to add any farm losses to its EDA account for the year, even though the loss was passed through to and currently deducted by a shareholder who had nonfarm income in excess of $50,000. This interpretation, of course, would permit an individual to use a subchapter S corporation to avoid the farm loss rules by separating his farming operations from his nonfarm income by placing the farm operations in a subchapter S corporation.

To clarify the fact that this result was not intended by Congress, the Act provides that in determining whether a subchapter S corporation has more than $50,000 of nonfarm income—and as a result must add its farm loss (in excess of $25,000) to its EDA account—its nonfarm income and the nonfarm income of whichever of its shareholders has the largest amount of nonfarm income for the taxable year involved are to be combined. If the combined amount exceeds $50,000, then the corporation's farm net loss (in excess of $25,000) must be added to its EDA account.

The second potential problem suggested in this area involved the possible use by an individual of multiple subchapter S corporations to carry on his farm loss business. It has been suggested each subchapter S corporation would receive the benefit of not having to add the first $25,000 of its farm net loss to its EDA account even though none of the corporations would receive this benefit if the individual himself had a farm loss rather than having the loss passed through by the corporations to him.

To clarify this matter, the Act denies the benefit of the $25,000 exclusion to a subchapter S corporation if anyone of its shareholders also is a shareholder of another subchapter S corporation that has a farm net loss for the year involved.

These amendments are to apply with respect to taxable years ending after December 10, 1971. No inference is intended, however, to be drawn from this effective date as to the treatment of these matters for prior years.

6. Capital gain throwback (sec. 306 of the Act and sec. 665(g) of the code)

The Tax Reform Act of 1969 added a new capital gain throwback rule to the tax law applicable in the case of certain trusts. When this rule applies and a beneficiary of a trust receives a distribution consisting of capital gains accumulated in prior years (beginning after 1968), he is taxed, in general, on these amounts as though they had been distributed by the trust in the year in which the trust realized the gain. A distribution of this type is referred to as a "capital gain distribution."

The definition of the term "capital gain distribution" for any taxable year of the trust includes the phrase, "to the extent of undistributed capital gain for such taxable year * * *." The reference here to the phrase "for such taxable year" can be interpreted as limiting to the amount of the current year's capital gains the amount of the capital gains of the trust available for a capital gain throwback to an earlier year. Under this interpretation, a trust could accumulate capital gains and then, in a later year when it had no undistributed capital gain, distribute the accumulated capital gains to a beneficiary without this resulting in tax. This is a result which would occur if the phrase "for such taxable year" is interpreted as limiting the capital gains throwback to the capital gain realized in the current year.

This interpretation is clearly inconsistent with Congressional intent and would nullify the purpose of the capital gains throwback rule. The Act deals with this problem by amending the definition of capital gain distribution by deleting the words "for such taxable year." This deletion makes it clear that a "capital gain distribution" for a taxable year includes the total undistributed capital gain for all years of the trust beginning after December 31, 1968, and ending before the year of distribution.

Since this amendment is a clarifying amendment, it is made effective with respect to taxable years beginning after December 31, 1968.

In the Tax Reform Act of 1969, Congress deferred the application of this capital gain throwback rule until 1972 where a person is a beneficiary of only one accumulation trust and that trust was in existence on December 31, 1969, or in the case of two trusts where one is for the lifetime benefit of a surviving spouse. In order to give more time to the study of the impact of this provision, the Act defers the application of this provision one more year until 1973.

7. Western Hemisphere Trade Corporation deduction (sec. 307 of the Act and sec. 921 of the code)

Under present law, a domestic corporation is entitled to a special 14-percentage-point rate reduction if it qualifies as a "Western Hemisphere Trade Corporation." A Western Hemisphere Trade Corporation is one all of whose business is done in the Western Hemisphere, 95 percent or more of whose gross income for the 3-year period which includes the current and the past 2 years comes from sources outside of the United States, and at least 90 percent of whose gross income for that period comes from the active conduct of a business.

A question was raised regarding the application of this provision in the case of a U.S. corporation doing a substantial volume of its business in the Virgin Islands. The Virgin Islands tax law generally is the so-called "mirror" of the U.S. tax law—that is, essentially its tax law is that provided by the Internal Revenue Code, except that, generally, wherever the words "United States" appear, this, in effect, is to be read as the Virgin Islands. A recent court case has held that a U.S. corporation deriving substantial income from the Virgin Islands was eligible for the Western Hemisphere Trade Corporation deduction with respect to its tax liability to the Virgin Islands. The effect of the court case in this situation could result in a tax reduction of 14 percentage points in Virgin Islands tax liability for U.S. businesses with substantial gross income from the Virgin Islands, and under the approval of the court it is also possible to interpret this 14-percentage-point tax benefit as applying to the Virgin Islands tax liability of Virgin Islands corporations.

The Congress decided that the Western Hemisphere Trade Corporation deduction should not result in a reduction in Virgin Islands tax liability for U.S. businesses with substantial gross income from the Virgin Islands, nor should it result in a reduction in Virgin Islands tax liability for Virgin Islands corporations, as this could cause a substantial loss of revenue to the Virgin Islands government. The solution to this problem contained in the Act is to, in effect, provide that the Western Hemisphere Trade Corporation deduction is not to be available to any corporation (United States or Virgin Islands) insofar as its Virgin Islands income tax liability is concerned (i.e., that the U.S. tax law, when applied in the Virgin Islands as the Virgin Islands tax law, does not contain the Western Hemisphere Trade Corporation reduced rate).

This provision is to be effective with respect to taxable years beginning after December 10, 1971.

In adding this provision to the bill, the Congress intends no inferences to be drawn as to what constitutes the appropriate interpretation of existing law in the cases affected by this amendment.

8. Capital gains and stock options (sec. 308 of the Act and sec. 58(g)(2) of the code)

Pursuant to the minimum tax provisions, stock options and capital gains which are derived from sources outside the United States are subject to the minimum tax for tax preferences only if the foreign country taxes them at a preferential rate. Prior to the enactment of this Act, the suggestion was made that no preferential treatment exists for this purpose where, for example, a capital gain is realized in a foreign country which imposes no, or only a very small, tax on all income (including capital gains).

It was not the intent of Congress to exclude capital gain (and stock option) income from the minimum tax in situations of this type. The Congress believed that there should be a clarification of the situations in which capital gain (and stock option) income attributable to foreign sources will be subject to the minimum tax. Accordingly, the Act provided that income of these types which is attributable to foreign sources is to be treated as receiving preferential treatment (and, thus, be subject to the minimum tax) if the foreign country imposes no significant amount of tax with respect to those items of income.

The types of situations in which capital gain income is to be treated as receiving preferential treatment under the Act include those where the country involved imposes either no tax or an insignificant tax with respect to capital gains or other income, or both.

In some situations, for example, where a gain may be considered to arise for U.S. tax purposes because of an allocation of income or a deemed distribution pursuant to the corporate reorganization provisions, a foreign country will impose no tax on capital gain income because the transaction in which the gain arises is not considered to be a taxable transaction or event under the laws of the foreign country, although it may be so considered under the laws of the United States. It is intended that in such a case, the minimum tax would not apply.

The amendment made by this provision applies to taxable years beginning after December 31, 1969, the date applicable to this provision under the Tax Reform Act of 1969.

9. Certain treaty cases (sec. 309 of the Act and sec. 7422(f)(1) of the code)

In 1966 Congress provided that civil actions for refunds in tax cases could be maintained only against the United States and not against an employee of the United States (e.g., a district director of the Internal Revenue Service). Inadvertently, this may have had the effect of denying persons the right to bring refund suits against the United States in tax cases arising under a tax treaty with another country. This is because under the judicial code (28 U.S.C. 1502) the Court of Claims (and correspondingly the District Courts), which are the forums in which tax refund cases generally are brought, are denied jurisdiction in cases against the United States which arise out of treaties with foreign countries.

It clearly was not the intent of Congress in enacting the 1966 legislation to deny a person the right to bring refund claims against the United States in cases where the claim arises out of a tax treaty. Persons bringing actions arising under a treaty for the refund of a tax should have the same right to bring suit as is available to taxpayers generally. Accordingly, the Act provided that tax refund suits and proceedings may be brought against the United States notwithstanding the provision of the judicial code (28 U.S.C. 1502) which denies jurisdiction to the Court of Claims (and correspondingly to the United States District Courts) in treaty cases generally.

The amendment made by this section is to apply to suits or proceedings which are instituted after January 30, 1967, the effective date of the 1966 legislation.

10. Denial of tax deduction with respect to illegal bribes, kickbacks, and other illegal payments (sec. 310 of the Act and sec. 162 of the code)

Under prior law, unchanged by this Act on this point, no deduction is allowed for fines or similar penalties paid to a government for violation of any law. Prior law also provided that no tax deduction was to be allowed for payment of illegal bribes or kickbacks where, as a result of the payment, there had been a successful criminal prosecution. If the bribe or kickback did not constitute a criminal act (presumably even if there was a loss of license), or if the taxpayer was not successfully prosecuted, the deduction was not disallowed under this provision. Also, under prior law the statute of limitations could be extended in bribe and kickback situations.

The Congress became concerned that these provisions might in some cases unduly restrict the denial of deductions. This was brought to the Congress' attention, for example, in the case of fees paid to individuals for referring patients under the medicare and medicaid programs. The Congress continued to believe that the determination of when a deduction should be denied should remain under its control. However, the Congress concluded that the area in which deductions are denied should be expanded somewhat beyond the limits of prior law.

Because of this view, the Congress added a provision to the Act to delete the requirement in prior law that a criminal conviction occur before a deduction for a bribe or kickback was denied. It also extended the denial of a deduction to other illegal payments. Thus, the Act provides that no deduction is to be allowed for an illegal bribe or kickback or other illegal payment in violation of either Federal or State law (but where the payment violates only State law, then only if the State law is generally enforced), if that law subjects the payor to liability for criminal penalties or the loss of license or privilege to engage in a trade or business. For this purpose, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof in respect to the issue as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment is to be upon the Secretary of the Treasury or his delegate to the same extent as he bears the burden of proof under section 7454 of the code, relating to fraud. The Act also eliminates the provision under which the statute of limitation for assessing deficiencies may be extended in these cases.

The Act provides that a deduction will be disallowed for any kickback, rebate, or bribe made by any provider of services, supplier, physician, or other person who furnishes items or services for which payment is or may be made under the Social Security Act, or in whole or in part out of Federal funds under a State plan approved under that Act, if the kickback, rebate, or bribe is made in connection with the furnishing of such items or services or the making or receiving of such payments. For this purpose, a kickback includes a payment in consideration of the referral of a client, patient, or customer.

Generally, the changes made with respect to illegal bribes, illegal kickbacks, and illegal payments apply with respect to payments made after December 30, 1969. However, the provision relating to kickbacks, rebates, and bribes under the Social Security Act applies only with respect to payments made on or after the date of enactment of the Act (December 10, 1971).

In connection with the proposed regulations relating to the disallowance of deductions for fines and similar penalties (sec. 162(f)), questions have been raised as to whether the provision applies only to criminal "penalties" or to civil penalties as well. In approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the Finance Committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute. The provision was intended to apply, for example, to penalties provided for under the Internal Revenue Code in the form of assessable penalties (subchapter B of chapter 68), as well as to additions to tax under the internal revenue laws (subchapter A of chapter 68) in those cases where the government has the fraud burden of proof (i.e., proof by clear and convincing evidence). It was also intended that this rule should apply to similar type payments under the laws of a State or other jurisdiction.

On the other hand, it was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with requirements of law. Thus, many jurisdictions impose "penalties" to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing charges or interest charges than they are fines. It was not intended that this type of sanction be disallowed under the 1969 action. Basically, in this area, the Finance Committee did not intend to liberalize the law in the case of fines and penalties.

11. Presumption with respect to farm losses (sec. 311 of the Act and sec. 183(e) of the code)

Under present law, a taxpayer is presumed to be engaged in an activity for profit for the current taxable year, unless established to the contrary by the Secretary of the Treasury or his delegate, if in two or more years of the period of five consecutive taxable years (seven consecutive years in the case of an activity which consists in major part of the breeding, training, showing, or racing of horses) ending with the current taxable year, the activity was carried on at a profit (i.e., if the gross income from the activity exceeds the deductions attributable to the activity which would be allowed if it were engaged in for profit). For purposes of this presumption, all deductions attributable to the activity other than that allowed for net operating loss carryover are taken into account.

It came to the attention of the Congress that if the period ending with the current taxable year does not include any taxable year in which a profit was made, the taxpayer is not being allowed to use the presumption even though there are, at that time, not 5 consecutive years (or 7 years in the case of horses) in which to measure the presumption. It is believed that this interpretation did not reflect the intent of Congress in originally adopting this provision. As a result, the Act provides that a taxpayer may elect to suspend the application of the presumption until there are 5 consecutive taxable years (or 7 years in the case of horses) in existence from the time the taxpayer first engages in the activity and then to apply it to any years in the

5-year period (7 years in the case of horses). For this purpose, a taxpayer is not to be treated as having engaged in an activity covered by this provision for any taxable year beginning before 1970.

Due to the 5- or 7-year periods involved in the case of the presumption, the statute of limitations may run before any action could otherwise be taken under the provision added by the Act. For this reason, the Congress believes that this provision should not generally be applicable unless the taxpayer executes a waiver of the statute of limitations for the 5- or 7-year period and for a reasonable time thereafter. This will allow the taxpayer time to claim any refunds of tax paid during this period and also will allow the Internal Revenue Service to assess any deficiencies.

This provision is effective with respect to taxable years beginning after December 31, 1969.

12. Dividend distributions in property to foreign corporations not engaged in business in the United States (sec. 312 of the Act and sec. 301 of the code)

Under present law, the amount of a distribution made in property (rather than money) by a domestic corporation differs in the case of shareholders which are not corporations from that applicable to corporate shareholders. In the case of a corporate shareholder receiving the property the amount of the distribution is its cost or other basis to the distributing corporation, if this is lower than the property's fair market value. The effect of limiting the amount considered a distribution in this manner is to specify that this is the largest amount which can be treated as a dividend out of earnings. The basis of the property received by the corporate shareholder is the same as the amount of the distribution which must be taken into income.

The committee reports accompanying the 1954 code make it clear that it is the intention of the present provision to make certain that the corporate shareholder receiving the property does not obtain a high basis without the payment of a significant dividend tax (because of the 85-percent dividends received deduction).[1] A high basis would, of course, decrease the gain on a later scale of the property or increase the depreciation deductions if the property is retained and used in the business.

A recent court decision has held that this treatment is applicable to distributions of property by a domestic corporation to a foreign corporate shareholder not doing business in the United States, although such a corporation does not receive a dividends received deduction (*Newman* v. *United States*), 423 F. 2d 49 (2d Cir. 1970)). Under this interpretation of the law, the foreign corporate shareholder can receive a distribution of appreciated property by paying a tax on its adjusted basis, and then sell the property without paying a U.S. tax on the appreciation. Thus, the treatment provided by present law

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[1] The committee reports accompanying the Internal Revenue Code of 1954 state that in the case of a distribution of property, the dividend income to a corporate shareholder is limited to the basis of such property in order "* * * to correlate the treatment of distributions in property to a corporate shareholder with section 243 of the bill (relating to the deduction for dividends received by a corporation)." It was further stated that: "This manner of treatment * * * insures that the adjusted basis of the property to the corporate recipient, for purposes of computing depreciation and gain or loss upon a sale or exchange will be the same as the adjusted basis to the distributor." (83rd Congress, 2nd Session, Report of Committee on Ways and Means to accompany H.R. 8300, House Report 1337, March 9, 1954, page A71.)

is not appropriate in the case of a foreign corporation since it is not subject to U.S. tax on a possible later sale of the property.

In view of the above, the Act provides that a distribution in property to a foreign corporation is to be treated as a distribution to the extent of the fair market value of the property. The basis to the distributee corporation, when the amount of the distribution is the entire fair market value, will also be such fair market value.

An exception to this rule is made in the case of distributions which are effectively connected with the conduct of a trade or business by the distributee foreign corporation within the United States. Since the business in such a case is treated essentially as a domestic business, the present treatment is retained.

The amendments made by this section of the Act are to be effective with respect to distributions made on or after November 8, 1971.

13. Original issue discount (sec. 313 of the Act and secs. 871, 881, 1441, and 1442 of the code)

In the Tax Reform Act of 1969, it was generally provided that original issue discount on corporate bonds issued after May 27, 1969, is to be taxed ratably to the holder of the bond, rather than upon the sale or redemption of the bond as was previously the rule. The latter rule, however, continues to apply to bonds issued on or before May 27, 1969.

Present law (which was not changed in 1969) also provides that nonresident alien individuals and foreign corporations are subject to a 30-percent tax (which generally is collected by means of a withholding tax) on the amount of gain arising on the sale or redemption of a bond (issued after September 28, 1965), that is treated as ordinary income because it is attributable to original issue discount. This rule was not coordinated with the ratable inclusion treatment provided in 1969 for original issue discount and therefore the law in effect after May 27, 1969, was unclear as to the manner in which original issue discount was to be treated in the case of bonds held by foreign persons.

The Congress believed this matter should be clarified and, accordingly, amended the rules of present law regarding the treatment of original issue discount in the case of nonresident alien individuals and foreign corporations. In general, it is provided that original issue discount on corporate and governmental bonds issued after May 27, 1969, is to be taxed to a holder of the bond who is a nonresident alien or foreign corporation upon the sale or redemption of the bond. However, in the case of bonds issued at a discount on which stated interest also is payable, the Act provides for ratable taxation of the discount. To the extent original issue discount is taxed in this manner, it is not to be again taxed upon the sale or redemption of the bond. In order to allow the Treasury Department time to develop regulations under this provision, these latter rules are not to apply to original discount on bonds issued arising prior to April 1, 1972.

The Act also provides an exclusion from tax for original issue discount on short-term obligations (those with original maturities of 6 months or less). This modifies prior law under which an exclusion applied where the foreign person held the bond for 6 months or less.

The Act also provides the Treasury Department with authority to provide for the application of the 30-percent withholding tax imposed on amounts paid to nonresident alien individuals and foreign corporations in the case of original issue discount. Generally, it is contemplated that, in the case of interest bearing bonds, it will be provided that the issuer of the bond is to withhold from payments of interest to the foreign holder not only the 30-percent tax on the interest but also an amount equal to the 30-percent tax on the original issue discount attributable to the period to which the interest relates (the total amount withheld is not to exceed the amount of interest paid).

If the taxpayer were a resident of a country with which the United States had an income tax convention providing for an exemption from or a lower rate of tax on interest payments, the exemption or lower rate would apply to both the discount and the interest.

Congress does not intend to imply how bonds held for six months or less are treated for tax purposes when held by United States persons.

14. Source of rental income from leases of ships or aircraft (sec. 314 of the Act and sec. 861(e) of the code)

One of the principal means available to finance the purchase of ships or aircraft is a leasing arrangement under which a financial institution (or other person furnishing the financing) purchases the ship or aircraft and then leases it to the air carrier or ship operator under an arrangement which is essentially similar to a sale of the ship or aircraft and a loan for the purchase price. The financial institution, which is allowed depreciation with respect to the ship or aircraft under present law and will be allowed the investment credit under the Act, in effect, passes all or a portion of these tax benefits on to the lessee in the form of reduced rentals for the ship or aircraft. In many cases this type of lease-financing transaction is the only means by which an air carrier or ship operator may obtain the financing needed to acquire the new equipment.

A problem has been called to the attention of the Congress with respect to the present treatment of these transactions which unless corrected, in effect, will make this type of financing unavailable with respect to ships or aircraft which are to be used in international commerce. Typically, under a leasing transaction of this type, the lease produces a tax loss during its early years to the lessor (primarily as a result of the depreciation deduction). Where the leased ship or aircraft is used in international commerce, the loss arising on the lease is considered to be a foreign source loss under the generally applicable source rules. The characterization of the loss as foreign source in combination with the limitation on the foreign tax credit can have the effect of causing the financial institution (or other person furnishing the financing) to lose a foreign tax credit to which it would otherwise be entitled for foreign taxes paid with respect to its foreign banking or other financial operations. This has the result of making this type of financing transaction substantially less attractive to the financial institution than a financing transaction involving equipment to be used in the United States. Moreover, if the "rentals" were considered to be interest, which in reality they are, the problems would not arise since under the generally applicable source rules interest paid by a U.S. person generally is considered to be from U.S. sources.

The Congress believed that it is desirable for this type of financing to be available in the case of ships and aircraft which are to be used in international commerce. Unless this means of financing is made available, the investment credit which is provided by the Act will not, in effect, be available with respect to ships or aircraft and thus will not have the stimulative effect in these sectors of the economy which the Congress considered desirable and necessary. Moreover, the Congress considered it more appropriate to view the "rentals" paid to a financial institution under a lease-financing transaction of this type as interest for source of income purposes.

Accordingly, the Act provides that a taxpayer who owns an aircraft or vessel which is qualified for the investment credit (sec. 38 property, or would be but for the fact that it is described in sec. 48(a)(5), relating to property used by governmental units) may elect to treat income or losses with respect to the aircraft or vessel (whether includible in income during or after the period of the lease), including gain or loss from the sale or disposition of the aircraft or vessel, as income from sources within the United States. This provision only applies if the aircraft or vessel is leased to a U.S. person (other than another member of the same group of controlled corporations), and only if the vessel or aircraft is manufactured or constructed in the United States. A taxpayer can make an election on an aircraft-by-aircraft or vessel-by-vessel basis. This election may be made for any taxable year ending after the commencement of the lease but remains in effect for all subsequent years unless revoked with the consent of the Secretary of the Treasury.

To insure the treatment of this income as U.S. source income, the Act specifies that it is to be treated as derived from U.S. sources regardless of the other source rules (for instance, under present law interest paid by a domestic corporation is treated as derived from foreign sources if less than 20 percent of the corporation's gross income is from U.S. sources).

It is the intent of Congress that if it should develop that taxpayers attempt to achieve U.S. source treatment for losses but foreign source treatment for income or gains, corrective measures will be considered.

A special rule is provided for those cases where an aircraft or vessel is transferred or distributed to another person who determines its basis by reference to its basis in the hands of the transferor or distributor. If this is the case and the aircraft or vessel was subject to an election under this provision, the transferee or distributee is treated as having made an election with respect to the aircraft or vessel transferred or distributed.

In adopting this amendment, Congress did not intend that any inference be drawn from the amendment as to the determination of whether a lease constitutes a sale or lease for purposes of other provisions of the tax law. This provision applies to taxable years ending after August 15, 1971, but only with respect to leases entered into after that date.

15. Industrial development bonds (sec. 315 of the Act and sec. 103(c) of the code)

Certain small issues of industrial development bonds are exempt from the rule which provides that industrial development bonds are not obligations on which the interest income is excluded from tax. Generally, these are issues of $1 million or less, but under certain conditions, they can be for as much as $5 million, paid or incurred for the same facility during a period beginning three years before and ending three years after the issue of the bonds. In addition, expenditures up to $250,000 may be disregarded, if they arise from unforeseen circumstances or mistakes of law or fact.

The Act retains the provisions of existing law with respect to the dollar limits (both the $1 million and $5 million limits) on small issues which are exempt from the industrial development bond rule, but increase from $250,000 to $1 million the amount of expenditures which may be disregarded in applying the conditions relating to issue of $5 million or less, where the expenditures are required by circumstances which could not be reasonably foreseen or arise out of mistake of law or fact. Included in these expenditures are expenditures necessitated by erroneous cost estimates, by increases in costs due to inflation, strikes, delays, or architectural modifications but not increases due to expansions.

Present law also exempts obligations issued for certain specified purposes from the industrial development bond rule. One of the specified purposes, prior to this Act, was facilities for the local furnishing of water. The Act eliminates the requirement that water facilities must be local and provides an exemption for facilities furnishing water, if the facilities are available on reasonable demand to members of the general public.

16. Disclosure or use of information by preparers of tax returns (sec. 316 of the Act and sec. 7216 of the code)

To assure that tax return information provided by a taxpayer to a tax return preparer is treated in a confidential manner, the Act provides a criminal penalty (a fine of up to $1,000 or not more than a year imprisonment, or both) if disclosure of that information is made. This provision applies to any person who is engaged in the business of preparing, or providing services in connection with the preparation of, returns of the tax imposed by chapter 1 of the Code, or declarations or amended declarations of estimated tax under section 6015, or any person who prepares any such return or declaration for another person for compensation. If one of these persons discloses any information furnished to him in connection with the preparation of the return or declaration, or uses the information for a purpose other than to prepare, or assist in preparing, the return or declaration, the Act provides that he will be guilty of a misdemeanor and upon conviction he will be subject to the criminal penalty referred to above.

The Act provided that certain uses will not be subject to the penalty. The tax return preparer may use the information obtained by him in his capacity as tax return preparer in the preparation of, or in connection with the preparation of, State and local tax returns and declarations of estimated tax. Also, the Act provides that the criminal penalty does not apply to disclosures of information which are made pursuant to another provision of this title or pursuant to an order of a court.

The Act also provides that the criminal penalty will not apply to a disclosure or use of information which is permitted by regulations prescribed by the Secretary or his delegate. Presumably, where appropriate, the Treasury Department will permit the use of information within the business organization of the preparer of the return if the taxpayer has indicated in writing that he desires the information to be used by the organization for some purpose specifically benefiting the taxpayer. The taxpayer could, for example, if the Treasury regulations permit, authorize the use of information in determining his qualifications for a loan from the same organization which prepared the return. Also, it is contemplated that the regulations would permit the use of the information outside of the organization of the preparer of the return but only with the taxpayer's consent.

This provision is to become effective on the first day of the first month which begins after the enactment of the Act (i.e., January 1, 1972).

D. Repeal of the Manufacturers Excise Tax on Passenger Automobiles, Light-Duty Trucks, Etc.

1. Repeal of the excise tax on passenger automobiles, light-duty trucks, etc. (secs. 401 (a) and (g) of the Act and sec. 4061 of the code)

Under prior law, the excise tax on passenger automobiles (imposed on the manufacturer's or importer's sales price) was 7 percent. However, the tax was to be phased out over a period of 10 years. The 7-percent rate was to continue through 1972. For 1973 there was a one-percentage-point reduction (to 6 percent) and for 1974 there was another one-percentage-point reduction (to 5 percent). For the period 1974 through 1977, the tax rate was to remain at 5 percent. Thereafter, the tax rate again was to decrease by one percentage point a year until 1982, at which time the tax was to be repealed.

The excise tax on trucks and buses, highway tractors, truck and bus trailers, and semitrailers presently is 10 percent. Present law provides that this is to be reduced to 5 percent on October 1, 1977.

Congress repealed the excise tax on passenger automobiles in this Act both to provide a stimulus for the purchase of cars and because of the jobs this was expected to create. In addition Congress has previously concluded that excise taxes such as the one on passenger automobiles are undesirable because they interfere with the freedom of consumer choice. The tax on light-duty trucks was repealed because, to a substantial degree, these trucks are used by many families in farm areas, as well as by other individuals, as a means of personal transportation comparable to the use made of passenger cars.

In repealing the excise taxes on passenger automobiles, light-duty trucks, etc., Congress intended that the full amount of the repealed tax be passed on to the consumer, thereby reducing the price of the automobile or the truck. The major automobile manufacturers have pledged to pass the tax reduction on to consumers. To give added assurance that this consumer benefit actually occurs and continues in the case of passenger automobiles and light-duty trucks, both the House Committee on Ways and Means and the Senate Committee on Finance requested that the Council of Economic Advisers review vehicle prices and report periodically to Congress regarding the extent to which the tax reduction is in fact being passed on. In addition, the Administration is to exercise all possible diligence and surveillance to see that these benefits are, in fact, passed on. The Committees on Ways and Means and Finance will follow these reports in considering whether the Congress should reimpose this tax.

In view of the considerations set forth above, the Congress repealed the 7-percent excise tax on passenger automobiles and also the 10-percent excise tax on light-duty trucks which have a gross vehicle weight of 10,000 pounds or less (as determined under regulations prescribed by the Secretary or his delegate).

Under the Act, the repeal is effective the day after the enactment of the Act (December 11, 1971), with floor stocks refunds and consumer purchases refunds (as described below) available with respect to passenger automobiles sold after August 15, 1971, and light-duty trucks sold after September 22, 1971.

Under prior law (sec. 4061(a)(2)) passenger automobile trailers and semitrailers (i.e., small auto-towed trailers "suitable for use in connection with" passenger automobiles) were taxed under the provisions applicable to passenger automobiles. The Act, therefore, repealed the tax on those articles.[1] Congress also believed it appropriate to repeal the tax on those trailers and semitrailers used with light-duty trucks on which the tax is repealed. Accordingly, the Act repealed the tax on those trailers having a gross vehicle weight of 10,000 pounds or less which are suitable for use with light-duty trucks.

Under present law, buses also are taxed in the same category as trucks (sec. 4061(a)(1)). Thus, the Act also repealed the tax on buses which fall within the 10,000-pound gross vehicle weight limit established for light-duty trucks.[2] In addition, the Act repealed the manufacturers excise taxes on urban mass transit buses and on trash containers for use in conjunction with trucks for solid waste disposal.

Generally, a truck or other automobile consists of two parts, namely, a body and a chassis. Technically, the tax applies to the sale by the manufacturer of each. In the case of bodies, an exemption is available (secs. 4063(b) and 4222(d)) when a body is sold by the body manufacturer to a manufacturer (but not an importer) of trucks. Thus, where a chassis manufacturer purchases a body tax free, he will pay the tax on his sale of the completed vehicle. Where a body manufacturer purchases a chassis on which a tax has been paid, he is liable for a tax based only on the sale price of the body.

Since truck chassis and truck bodies are frequently sold separately by their respective manufacturers, the light-duty truck exemption applies to a chassis or a body that is suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less. This means that if a truck chassis manufacturer sells a chassis which is suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less, the chassis will be exempt from the 10-percent excise tax regardless of the body that may actually be mounted on it. However, chassis modifications constituting further manufacture of the chassis at any time before use and subsequent to the manufacturer's sale may result in a tax being imposed on the subsequent manufacturer's sale (or use), if the modified chassis is suitable for use with a vehicle having a gross vehicle weight in excess of 10,000 pounds. A body that may be suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less is similarly exempt even though it may also be suitable for use with (and actually be mounted on) a chassis that is suitable for use with a vehicle in excess of this weight limitation. (In this latter case, however, the chassis would be subject to the 10-percent tax.) In general, it is expected that this exemption for light-duty trucks which have a gross vehicle weight of 10,000 pounds or less will exempt half-ton, three-quarter-ton, and some one-ton trucks.

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[1] Most of the references in this report to automobiles apply also to these small trailers.
[2] The references in this report to light-duty trucks apply also to any such small buses.

The exclusion from the 10-percent truck excise tax for light-duty trucks includes the original equipment on the truck when it is sold. That is, parts and accessories that in the past have been subject to the 10-percent truck tax because of the sale of the truck, in the future are not to be subject to the parts tax. This means that parts and accessories which are sold with the truck (or ordered at the time of sale), and would have been taxed under sec. 4061(a) of prior law, are not to be subject to tax. This is not intended to cover replacements 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. The Act does not, however, affect the application of the 8-percent tax on truck parts and accessories sold subsequent to the sale of the truck.

The Secretary or his delegate is to prescribe in regulations a standard for determining the gross vehicle weight. This standard will not necessarily be the gross vehicle weight as specified by a manufacturer, a Federal agency providing rules for purposes other than this manufacturers excise tax, or any State.

In the case of a sale of an ambulance, hearse, or combination ambulance-hearse, prior law (sec. 4062(b)) treated these vehicles as passenger automobiles so that the 7-percent automobile excise tax applied to them. In order to preserve the passenger autombile treatment, the Act exempted these vehicles from the excise tax on trucks.

2. Floor stocks refunds (secs. 401(b) and (g) of the Act and sec. 6412 of the code)

Under prior law, (sec. 6412(a)(1)), floor stocks refunds would have been made available in regard to passenger automobiles on the various tax reduction dates which were to be effective (in the absence of this Act) in the years 1973 through 1982. (Floor stocks refunds continue to be provided in the case of rate reductions on trucks, buses, trailers, etc., scheduled for October 1, 1977.)

To avoid creating competitive disadvantages because of the relative sizes of dealers' inventories and in conformity with prior practice, the Act makes provision for floor stocks refunds with respect to passenger cars and light-duty trucks in dealers' inventories on December 11, 1971 (the day after the date of the enactment of the Act). These floor stocks refunds (or credits) are available with respect to passenger automobiles, light-duty trucks, etc., sold by the manufacturer or importer before the tax repeal date (December 11, 1971), which are still held by the dealer on that date, and which have not been used but are intended for sale by him. The credits or refunds for these floor stocks must be claimed by the manufacturer or importer before the first day of the 10th calendar month beginning after the tax repeal date (that is, before October 1, 1972), based upon reports submitted to him from the dealer before the first day of the 7th calendar month beginning after the tax repeal date (that is, before July 1, 1972). Also, before October 1, 1972, the manufacturer or importer must have reimbursed the dealer for the tax or obtained his written consent to the allowance of the refund or credit. In addition, the manufacturer or importer must have in his possession evidence of the inventories on which the credit or refund is claimed (to the extent required by regulations prescribed by the Secretary of the Treasury or his delegate).

A passenger automobile or light-duty truck is not to be treated as having been sold before the tax repeal date (and, generally, is to be treated as being in the dealer's inventory on that date) unless possession or right to possession of the vehicle passes to the purchaser before that date.

In high-volume situations, where it is impossible or highly impractical to determine the exact amount of the tax on a vehicle-by-vehicle basis, it was contemplated that manufacturers would be able to comply with the floor stocks refund requirements on an average basis. For example, since manufacturers' transportation expenses were excludable from the rate base upon which the passenger automobile tax was imposed (sec. 4216(a)), it was expected that manufacturers would be permitted to compute the credit for any one class of passenger cars (automobiles of the same model, which were sold by the manufacturer with the same equipment and accessories) by reducing the actual sale price by the average transportation costs for that class of passenger cars. Such procedures were used in connection with the Excise Tax Reduction Act of 1965.

Congress expected that these floor stocks refund claims would be processed promptly, and anticipated that the Internal Revenue Service would make refunds within 45 days of the receipt of the claims. There was no intention to have the Government unreasonably retain these excess taxes or to have the manufacturers be out-of-pocket the amounts of these taxes for an extended period of time. Indeed, any such unnecessary delays would tend to detract from the stimulative purposes of these provisions.

3. Refunds with respect to certain consumer purchases (sec. 401(c) of the Act)

In connection with the repeal of the excise tax on passenger automobiles, the Act also made provision for refunds of the excise tax to consumers with respect to their purchases after August 15, 1971, and before December 11, 1971 (when the tax was actually eliminated). In addition, the Act provided for consumer refunds in the case of the excise tax on light-duty trucks and buses purchased by consumers after September 22, 1971, and before December 11, 1971. Provision for these refunds was necessary to forestall the postponement of purchases of the cars and light-duty trucks until the date of the repeal of the tax. This provision is consistent with Congress' actions in 1965 with regard to passenger automobiles and air conditioners—articles where it was thought delays in purchases might adversely affect total sales.

The Act provides that the government is to refund (or credit) to the manufacturer (or importer) of the tax-repealed automobile, truck, etc., the tax he paid on his sale of the article. However, to obtain this refund (or credit) the manufacturer (or importer) must file his claim with the Internal Revenue Service before the beginning of the 10th calendar month beginning after the day the tax was repealed (that is, before October 1, 1972). This claim is to be based on information submitted to him by the dealer (or other person) who sold the article to the ultimate purchaser. This information must be submitted to the manufacturer before the first day of the 7th month after the date of repeal (that is, before July 1, 1972). Also, before October 1, 1972, the "ultimate purchaser" must have been reimbursed for the tax paid on the article he purchased.

The "ultimate purchaser" is the consumer or user of the new article. This includes a dealer in the case of a driver-training car where he retains ownership, a demonstrator (unless sold as a new car, in which case see the discussion below) or any other car owned by him and used in his business, and a lessor with respect to a leased car.

A passenger automobile is not to be treated as having been sold before August 16, 1971 (or light-duty truck before September 23, 1971) unless possession or right to possession of the vehicle passed to the purchaser before that date.

It was expected that a consumer who purchased a passenger automobile or light-duty truck during the post-August 15 or post-September 22 period would be informed that, if these excise taxes were repealed, he would be refunded the amount of the tax. In these cases the dealer was to notify the manufacturer as to the persons to whom he sold specific automobiles, trucks, etc., during the refund period. This notification must have reached the manufacturer before the beginning of the 7th calendar month after the repeal of the tax (that is, before July 1, 1972). This was done to give the manufacturer time to process the claims, make reimbursements, and file his overall claim (or claims) with the Internal Revenue Service before October 1, 1972. The reimbursement could have been made directly by the manufacturer to the consumer or could have been made through the dealer who originally sold the article.

As with floor stocks refunds, in high-volume situations where it is impossible or highly impractical to determine the exact amount of the tax on a vehicle-by-vehicle basis, it was contemplated that manufacturers could comply with the consumer refund requirements using a limited amount of averaging. For example, since manufacturers' transportation expenses were excludable from the rate base upon which the passenger automobile tax was imposed, it was expected that manufacturers would be permitted to compute the credit for any one class of passenger cars by reducing the actual sale price by the average transportation costs for that class of passenger cars. This method was not to be permitted unless the manufacturer demonstrated that the refunds to consumers would not be less than the aggregate of the taxes that had previously been passed on to the consumers on account of consumer purchases during the relevant period (i.e., after August 15 or September 22). Apart from the averaging device just described, and similar adjustments where this is found necessary, the entire tax that had been passed on to a consumer was to be refunded to the consumer for the manufacturer to obtain any refund under this provision. These procedures are the same as those used after the Excise Tax Reduction Act of 1965.

Congress intended and expected the Internal Revenue Service to allocate the necessary personnel to process consumer refund claims as soon as possible. The manufacturer was not to be permitted to claim a refund until he showed he had already reimbursed the ultimate purchaser. However, there was no intention that the government delay refunding taxes or that the manufacturers be out-of-pocket for the taxes any longer than was necessary for administrative reasons. Indeed, any unnecessary delays would detract from the stimulative purposes of these repeal provisions.

4. "Demonstrator" vehicles

The floor stocks refunds and consumer refunds provided by this Act were to be available only in the case of "new" tax-repealed articles sold during the periods described above or held by a dealer at the time the repeal of the taxes became effective. Questions arose as to whether "demonstrators" are new for this purpose. "Demonstrators" are passenger automobiles and light-duty trucks used by a dealer's sales personnel for a period of time and then sold.

Congress believed that "demonstrators" should be treated as "new," and thus entitled to the consumer or floor stocks refunds, where they were intended for sale as new vehicles rather than as used ones. In the case of passenger automobiles, in order for a demonstrator to be considered sold as new (or in the dealer's inventory as a new car on the tax repeal date), the dealer must show that the label required by the Automobile Information Disclosure Act of 1958 (Public Law 85–506) was affixed to a window of the vehicle when the vehicle was sold (or was in the dealer's inventory on the tax repeal date). In addition, the dealer must show either that the vehicle was sold (or was to be sold) under a full written or express warranty by which the manufacturer is obligated to the consumer, or must show "newness" by other evidence acceptable to the Internal Revenue Service. It was anticipated that the Internal Revenue Service would provide that a written or express warranty would not be considered to be a full warranty unless more than 50 percent of the mileage and time-period coverage was unexpired on the date the vehicle was sold (or was held for sale in the dealer's inventory on the tax repeal date). However, a resale of a vehicle would never be considered to be the sale of a new vehicle even if more than 50 percent of the mileage and time-period coverage was unexpired on the date the vehicle was sold (or was held for sale in the dealer's inventory on the tax repeal date).

Where after August 15 and before the day after the date of enactment of the Act (December 11, 1971), a dealer purchases a passenger automobile from a manufacturer and the automobile is used by the dealer as a demonstrator, but not in a manner which qualifies it as a new automobile, the dealer would be considered the ultimate purchaser and therefore eligible for a consumer refund. This would be true even if the dealer sold the car to a consumer as a used car prior to the day after the date of enactment. (For administrative purposes, however, the Internal Revenue Service may decide to permit the dealer to elect (with the consent of the manufacturer) to include such an automobile in his floor stocks inventory (whether or not held by the dealer on December 11, 1971) as an alternative to requesting separate reimbursement under the consumer refund provisions of the Act.)

In the case of light-duty trucks used by the dealer as "demonstrators," there is no stautory requirement that the truck display any label. As a result, although generally the same circumstances described above for automobiles used as demonstrators apply in the case of light-duty trucks used as demonstrators (except that, for light-duty trucks the manufacturer must have sold the vehicle after September 22 instead of after August 15), there is to be no requirement that a label be displayed.

In the case of cars that have been made available by a dealer for student training purposes before August 16 and which are returned to the dealer and sold after August 15, the Congress believed they should be treated in the same manner as demonstrator cars; that is, for a student training car to be considered as a new car, it must have the label affixed to a window of the vehicle when it was sold (or in the dealer's inventory on the tax repeal date) and the remaining warranty on the car must have been more than 50 percent of the mileage and time-period coverage of the original warranty.

5. Certain uses by manufacturer, etc. (sec. 401(d) of the Act and sec. 4218 of the code)

Under prior law, if a manufacturer (or importer) of a passenger automobile or a light-duty truck, used the vehicle himself (other than in the manufacture of another taxable article), he was liable for tax in the same manner as if the article were sold by him. In this case the tax was computed on the price at which he (or other manufacturers or importers) sold the same or similar articles in the ordinary course of trade.

Congress believed that where a manufacturer (or importer) paid a tax on account of his use of the article during the consumer refund period, he was as much entitled to reimbursement as would be any other consumer. Accordingly, the Act provided that where an automobile or light-duty truck was used by a manufacturer (or importer) and as a result of this use a tax was paid after August 15, 1971, in the case of automobiles (or September 22, 1971, in the case of light-duty trucks), the payment was to be treated as an overpayment. The effect of this is to entitle the manufacturer (or importer) to a refund (or credit). In such a case, of course, the subsequent sale of the vehicle would not also give rise to a consumer refund or a floor stocks refund.

6. Tires on imported vehicles (sec. 401(f) of the Act and sec. 4071(e) of the code)

Under present law, highway vehicle tires and inner tubes are subject to a manufacturers excise tax of 10 cents a pound. In the case of original equipment tires on domestic automobiles and trucks a credit was provided for the tax paid on these tires to prevent a double tax—the tire tax and the automobile or truck tax. In other words, a credit was allowed against the 7-percent excise tax on automobiles (or 10 percent tax on trucks) for 7 percent (or 10 percent in the case of trucks) of the purchase price of the tires. In the case of imported automobiles and trucks, however, the original equipment tires were not subject to a separate tire tax.

Congress concluded that it was appropriate to provide that original equipment tires on imported vehicles (other than bicycles), equipment, and implements are to be subject to the tire tax, thereby equalizing in this respect the excise tax treatment of domestic and imported vehicles. The proceeds of this tire tax are transferred to the Highway Trust Fund (as was already true in the case of domestic tires and of imported tires other than those brought in mounted on imported vehicles).

7. Other technical changes

Small three-wheeled motor vehicles (sec. 401(g) of the Act and sec. 4063 of the code).—Under prior law the excise tax on trucks did not apply to any small three-wheeled vehicle whose chassis weighs not more than 1,000 pounds and which is powered by a motor which does not exceed 18 brake horsepower (rated at 4,000 revolutions per minute). Since the Act repealed the tax on light-duty trucks, which have a gross vehicle weight of 10,000 pounds or less, Congress concluded that there was no need to continue the exemption for the small three-wheeled motor vehicles since these vehicles would in any event be free of tax under the exemption for light-duty trucks. Accordingly, the Act repealed the exemption for these small three-wheeled vehicles.

Rate of tax stated on new car labels (sec. 401(g) of the Act).—The Excise, Estate, and Gift Tax Adjustment Act of 1970 (sec. 304 of that Act, 15 U.S.C. 1232(a)) provided that where a manufacturers excise tax is imposed under the Internal Revenue Code on a sale of a new automobile, which is required by the Automobile Information Disclosure Act to have a label affixed to it, the person required to affix the label must also state on the label that the Federal manufacturers excise tax was imposed and the percentage rate at which the tax was imposed. Since this Act repealed the excise tax on automobiles, there was no reason to continue this provision. Accordingly, this Act repealed the 1970 Act's label information requirement, effective after December 10, 1971 (the date of the enactment of this Act).

Installment sales, etc. (sec. 401(h) of the Act and sec. 4216(c) of the code).—In the case of partial payment in connection with leases, certain types of installment sales, conditional sales, or certain types of chattel mortgage arrangements, present law provides that the manufacturers excise tax is to be paid upon each partial payment and is to be based on the tax rate in effect on the date each partial payment is due. To avoid windfall benefits to a manufacturer where the lease, installment sale, etc., took into account the 7-percent or 10-percent tax, the Act provided that no tax is due on partial payments after the tax repeal date if the lessor or vendor establishes that the amount of the payments payable after that date has been reduced by the amount of tax that would otherwise have been due with each partial payment after that date. If the lessor or seller does not reduce the amount of the payments, however, the tax reduction provided by the Act will not apply to the article on which those partial payments are being made. In other words, for the tax reduction to be available in partial payment cases, the benefit of the repeal must be passed on to the lessee or purchaser.

8. Effective date (sec. 401(h) of the Act)

Except in the case of installment sales, etc. (described above), the repeal of the excise tax on passenger automobiles, light-duty trucks, etc., applies to articles sold on or after the day after the date of the enactment of the Act (that is, on or after December 11, 1971).

The Act also provides that an article is not to be considered as sold before the day after the date of the enactment of the Act unless possession or right to possession passes to the purchaser before that day.

9. Revenue effect

The revenue loss from the repeal of the excise tax on passenger automobiles is estimated to be $2.2 billion for the fiscal year 1972, $2.0 billion for the fiscal year 1973, and $1.8 billion for the fiscal year 1974. This decline in revenue loss is due to the scheduled decrease in the tax rate under prior law from 7 percent for 1972 to 6 percent for 1973.

and to 5 percent for 1974. The long-run revenue loss from the immediate repeal by the Act will be further reduced by the scheduled phaseout under prior law of the tax and its eventual repeal as of January 1, 1982.

It is estimated the repeal of the excise tax on light-duty trucks and buses will result in a revenue loss of $280 million for the fiscal year 1972 and $360 million for the fiscal year 1973. This revenue loss will come out of the Highway Trust Fund. For the fiscal year 1973, estimated receipts from the tax on light-duty trucks under prior law would represent about 50 percent of the projected $720 million in revenues under prior law from the tax on all trucks and buses and approximately 6 percent of the total Trust Fund revenues of $5.9 billion. In addition, the repeal of the excise tax on trailers having a gross vehicle weight of 10,000 pounds or less used with light-duty trucks results in a revenue loss from the Highway Trust Fund estimated at $3 million. The extension of the tire tax to imported vehicles not subject to the auto or truck taxes is expected to produce approximately $25 million per year for the Highway Trust Fund.

E. Credit Against the Occupational Tax on Coin-Operated Gaming Devices

(Sec. 402 of the Act and sec. 4464 of the code)

Present law (unchanged by the Act) imposes a $250 annual special tax on any person who maintains or permits the use of a "coin-operated gaming device" on his premises (sec. 4461). A separate tax is payable for each such device. A "coin-operated gaming device" is defined (sec. 4462), in general, as a slot machine which provides prizes on the basis of chance to the person operating the machine.

For many years, the Congress has exempted legal parimutuel operations from the wagering tax. In 1965, the Congress exempted State-run lotteries from the wagering tax. In line with those precedents, and in order to not interfere unduly with State decisions to derive revenue from taxes imposed on slot machines, the Congress decided, in this Act, to allow a credit against the Federal slot machine tax for similar taxes (other than general personal property taxes) paid to a State government, up to a maximum of 80 percent of the Federal tax.

The credit is available only where the slot machine is located in the State to which the State tax is paid, and only where the maintenance of the slot machine does not violate the laws of that State.

Where the Federal tax is to be paid for a period before the State tax is to be paid for that period, authorization is provided for reduction of the Federal tax payment by the estimated amount of the credit to be allowed for payment of the State tax.

This provision, which went into effect on July 1, 1972, is expected to reduce Federal revenues by about $10 million a year, if all States with slot machines enact taxes which may be credited against the Federal tax.

F. Domestic International Sales Corporations

As indicated in the discussion of the reasons for the Act, the Congress believes that it is important to provide tax incentives for U.S. firms to increase their exports. This is important not only because of its stimulative effect but also to remove a disadvantage of U.S. companies engaged in export activities through domestic corporations. Prior to enactment, they were treated substantially less favorably than those which manufacture abroad through the use of foreign subsidiary corporations. United States corporations engaging in export activities were taxed currently on their foreign earnings at the full U.S. corporate income tax rate regardless of whether these earnings were kept abroad or repatriated. In contrast, U.S. corporations which produce and sell abroad through foreign subsidiaries generally can postpone payment of U.S. tax on these foreign earnings so long as they are kept abroad.

In addition, other major trading nations encourage foreign trade by domestic producers in one form or another. Where value added taxes or multistage sales taxes are used to any appreciable extent, the practice is to refund taxes paid by the exporter at the time of export and to impose these taxes on importers. In the case of income taxes as well, however, most of the major trading nations have features in their tax laws which tend to encourage exports. Both to provide an inducement for increasing exports and as a means of removing discrimination against those who export through U.S. corporations, the Act provides a deferral of tax where corporations meeting certain conditions—called Domestic International Sales Corporations—are used.

1. An overall view

For the reasons discussed above, the Act provides a system of tax deferral for a new type of U.S. corporation known as a Domestic International Sales Corporation, or a "DISC," and its shareholders. Under this tax system, the profits of a DISC are not to be taxed to the DISC but instead are to be taxed to the shareholders when distributed to them. However, Congress believes that the tax deferral treatment made available to a DISC should be limited. Therefore, it has provided that deferral is to be available for 50 percent of the export income of a DISC.

The deferral of tax accorded to profits earned by the DISC ends not only when those profits are distributed to the DISC's shareholders but also when the DISC fails to continue qualifying as a DISC (in this case the profits are taxed to the shareholders as "deemed" distributions). For example, when a DISC's profits are distributed to a corporate shareholder, the shareholder is treated in most respects as if it were the initial recipient of the profits; as a result, no intercorporate dividends received deduction is available for these profits, but instead the profits are treated as foreign source income and the shareholder is allowed to credit against its tax liability on these profits any income taxes paid to a foreign country (by the DISC or a subsidiary of the DISC, but this income cannot be used to offset unrelated foreign tax credits even if the shareholder is on the "overall limitation").

To qualify as a DISC, at least 95 percent of a corporation's gross receipts must arise from export sale or lease transactions and other export-related investments or activities. In addition, at least 95 percent of the corporation's assets must be export related. Included in export-related assets are "producer's loans" which are loans (subject to certain restrictions) made to the U.S. parent producer (or any other U.S. exporter) to the extent of the producer's assets used for export business. These loans by a DISC do not give rise to taxation of the DISC or the parent on the amounts loaned.

The Congress was concerned that the tax-deferred profits of a DISC which are loaned to the DISC's parent company (or affiliated company) may be used for investments in foreign plant and equipment by the parent (or domestic or foreign affiliate). To limit this possibility, it has provided that to the extent the controlled group, which includes the DISC, invests profits of the DISC in foreign plants and equipment, deferral is to cease with respect to the profits. The group is treated as having invested the DISC profits in this manner to the extent the group's investments in foreign plant and equipment are in excess of specified amounts of foreign source capital of the group (generally, one-half the amount of the earnings of (and fees and royalties paid to domestic members of the group by) the foreign affiliates, the amount of capital—debt or equity—raised abroad by the group, additions to foreign depreciation reserves by the group, and the uncommitted transitional funds of the group).

Although up to 50 percent of the income of a DISC is not to be subject to current taxation, each year a DISC is deemed to have distributed to its shareholders certain types of its income, thus, subjecting that income to current taxation in the shareholder's hands. The principal types of income falling in this category are the income representing 50 percent of the DISC's income, the interest realized by the DISC on its "producer's loans," and any amount of a producer's loan that is considered invested in foreign plant and equipment.

Generally, present law requires sales between a parent corporation and its subsidiary to be made on an arm's length basis; that is, at the price the parent company would have charged an unrelated third party. Special pricing rules in the Act permit a DISC to earn a larger relative amount of the profits arising on sales by the DISC of its parent company's export products.

2. Taxation of a DISC (sec. 501 of the Act and sec. 991 of the code)

As a general rule, the Act provides that a DISC is not to be subject to income taxes (or more specifically the taxes imposed by subtitle A other than the tax imposed by chapter 5) although its shareholders are taxed on an amount representing 50 percent of the DISC's income. The remaining 50 percent of the profits of a DISC are to be fully free of tax in the hands of the DISC (as discussed subsequently, these profits will be subject to tax in the hands of the shareholders when distributed or deemed distributed). Both the determination of whether a corporation qualifies as a DISC and the tax deferral provided by the Act apply on a year-by-year basis. The taxes foregone in the case of a DISC include not only the regular corporate income tax, but also the minimum tax on tax preferences, and the accumulated earnings tax. Since a personal holding company cannot qualify as a DISC, the Act does not relieve a corporation from this tax (sec. 541 of the code).

3. Requirements of DISC (sec. 501 of the Act and sec. 992 of the code)

Definition of "DISC" and "former DISC".—The Act provides that a corporation will qualify as a DISC for a taxable year if four requirements are satisfied with respect to the taxable year: the gross receipts test, the assets test, the capitalization requirement, and the election requirement. A DISC, also, must be an incorporated entity (under the laws of any State or the District of Columbia) and, thus, associations otherwise treated as corporations under the code may not qualify as a DISC.

First, at least 95 percent of a corporation's gross receipts (defined in sec. 993(f)) for the taxable year must be composed of qualified export receipts. As discussed subsequently, qualified export receipts include receipts arising on the sale or lease of export products as well as receipts from other specified export-related activities. In addition, where a corporation seeking to qualify as a DISC sells products of a U.S. manufacturer on a commission basis (rather than on a purchase and resale basis), the amount of gross receipts arising on the commission sale is to be the gross receipts from the sale of the property which gave rise to the commission.

Second, at least 95 percent of the assets of a corporation at the close of its taxable year must be qualified export assets (determined with reference to the adjusted basis of the assets).

Third, to qualify as a DISC, a corporation must have at least $2,500 of capital (on each day of the taxable year as measured by the par or stated values of its outstanding stock). This test is designed to make sure that a corporation may qualify as a DISC even though it has relatively little capital. It is recognized that this rule constitutes a relaxation of the general rules of corporate substance. The separate incorporation of a DISC is required to make it possible to keep a better record of the export profits to which tax deferral is granted, but this does not necessitate in all other respects the separate relationships which otherwise would exist between a parent corporation and its subsidiary. This, however, is not intended to lessen the general rules of corporate substance required for other corporations in other contexts.

The capitalization requirement also precludes a DISC from having more than one class of stock. This requirement is included in view of the complexity which would result under a deferral system of taxation if the corporation were allowed to have more than one class of stock. For example, if more than one class of stock were allowed where the DISC's earnings must be deemed paid to its shareholders, it would have been necessary to include in the Act a special set of rules specifying how the earnings would be allocated to each class of stock.

Fourth, to qualify as a DISC for any year, a corporation must have elected to be treated as a DISC.

The rules provided by the Act are to apply to a corporation and its shareholders for any year in which it is a DISC and for any year in which, although it is not a DISC for that year, there are potential tax consequences arising from the fact that it was a DISC for a prior year. In the latter case the corporation is considered a "former DISC." There are two potential tax consequences resulting from the fact that the corporation was a DISC in a preceding taxable year: the corporation may have undistributed amounts of tax deferred income which are to be taxed to its shareholders or it may have undistributed amounts of income which previously had been taxed to the shareholders but not actually distributed to them.

In addition, provision is made for regulations to provide rules dealing with a corporation which has filed a return as a DISC and subsequently claims that it is not eligible for DISC status. The regulations are to provide that in the case of a corporation which has not indicated more than 30 days before the running of the statute of limitations for the year that it is not a DISC and has filed a tax return as if it were a DISC, then the corporation (and its shareholders with respect to distributions or deemed distributions from the corporation) is to be treated as if it were a DISC for the year in question, if the Internal Revenue Service has not issued a notice of deficiency based upon a determination that the corporation was not a DISC.

Election to be treated as a DISC.—For a corporation to qualify as a DISC under the election referred to above, it must (except as otherwise provided in rules prescribed by the Treasury) make the election during the 90-day period immediately prior to the beginning of the taxable year. In addition, for the election to be valid, all of the persons who are shareholders on the first day of the initial election year must consent to the election. The requirement that the shareholders consent to the election need not be satisfied on the first day of the first taxable year for which the election is effective. It is anticipated the corporation will be given a reasonable period of time to obtain these consents. However, if it fails to obtain all of these consents within the time specified, except where the statute has run and it has not been determined that the corporation was not a DISC (sec. 992(a)(2)) the corporation will not be treated as a DISC.

Once made, an election continues in effect for subsequent years whether or not the corporation actually qualifies as a DISC in a given subsequent year, until such time as the election is either revoked or is terminated by reason of a continued failure over a 5-year period of the corporation to qualify as a DISC. The purpose of this provision is to make it unnecessary for a corporation to make a new election each year to qualify as a DISC. If a corporation makes a valid election to be treated as a DISC, the rules provided by the Act apply to the corporation and to all persons who are shareholders of the corporation at any time on and after the election becomes effective (i.e., not only the initial shareholders but their successors in interest as well).

An election to be treated as a DISC may be revoked at any time after the first year it is in effect. For a revocation to be effective for a given year, however, it must be made within the first 90 days of that year. A revocation made after the expiration of the 90-day period will not take effect until the following year. The Act also provides for the automatic termination of an election where the corporation does not qualify as a DISC for a period of five consecutive taxable years.

An election to be a DISC has continuing effect except where it is terminated voluntarily or where the corporation fails to qualify for a 5-year period, in order to prevent the termination of the election inadvertently through unintentional disqualification in one or more years. However, even where a DISC election has been terminated voluntarily or under the 5-year rule, the corporation would be permitted to make a new election in the future to be treated as a DISC if it so desires.

Distribution to meet qualification requirements.—The Act provides for situations under which a corporation may distribute its nonqualified receipts or assets after the end of the taxable year, in order to satisfy the 95-percent gross receipts and 95-percent assets tests for a year. The purpose of this is to prevent a corporation from failing to qualify for DISC treatment in a year merely because of its failure to meet the gross receipts or assets test.

The amount a corporation must distribute under the distribution rules set out below is the sum of (A) the portion of its taxable income attributable to its nonqualified gross receipts (if it fails to satisfy the gross receipts test) plus (B) the fair market value of the nonqualified export assets held by it on the last day of the taxable year (if it fails to satisfy the assets test for the year). In either case the entire nonqualified amount must be distributed and not merely an amount equal to the extent to which the corporation failed to satisfy the test or tests in question. In determining the portion of a corporation's taxable income attributable to nonqualified gross receipts, the entire amount of the gross income from nonqualified receipts to which expenses are not definitely allocable, such as dividends, will be taken into account. On the other hand, where expenses are properly allocable to income, the expenses are to be considered as reducing the nonqualified gross income.

Also, under both rules a distribution will not cause a corporation to qualify as a DISC unless it is a pro rata distribution to the shareholders with respect to their stock and is specifically designated when made as a distribution to meet qualification requirements. In other words, a corporation which made a normal dividend distribution and which consequently discovered that it did not qualify as a DISC for the preceding year is not to be permitted to redesignate the initial dividend distribution as a distribution to enable the corporation to qualify as a DISC.

As subsequently discussed, distributions to meet qualification requirements will be fully taxable to the shareholders of the corporation. The dividends received deduction is not to be available with respect to these distributions and, in addition, the distributions are to be treated as U.S. source income (since they are not attributable to qualified export receipts) and thus will not have foreign tax credit consequences.

One distribution rule is designed to apply in those cases where a corporation comes relatively close to satisfying the gross receipts or assets tests. A corporation which has failed to satisfy either the gross receipts or assets test is deemed to have acted with reasonable cause with respect to both the failure to meet those tests and the failure to make the distribution prior to the time the distribution is made if at least 70 percent of the corporation's gross receipts for the year are qualified export receipts and at least 70 percent of the assets held by the corporation on the last day of each month of the year are qualified export assets, and if it makes a distribution of the appropriate amount within 8½ months after the close of the taxable year. For this purpose all assets are taken into account at their adjusted basis. Where these conditions are satisfied, a corporation will be treated as having satisfied the gross receipts and assets test for the taxable year.

A second distribution rule is designed to deal with the situation where there is both reasonable cause for a corporation's failure to meet the gross receipts or assets test and reasonable cause for its failure to make the distribution earlier than when it was made. Where there is a reasonable cause, the required distribution may be made whether or not less than 70 percent of the corporation's gross receipts or assets were qualified.

In addition, in this situation, the corporation is not required to make the distribution within the 8½ months after the end of the year, as required by the first distribution rule, if the failure to make the distribution to meet the gross receipts or assets test within 8½ months and before the date when actually made is due to reasonable cause. Examples of conditions that may be reasonable cause are blocked foreign currency and foreign expropriation. If conditions exist which constitute reasonable cause but subsequently no longer exist, the regulations are to provide that a corporation will no longer have reasonable cause for failure to make a distribution after the 90th day after the conditions constituting reasonable cause no longer exist.

Generally, the reasonable cause requirement is to be considered as being satisfied where the action or inaction which resulted in the failure to meet the gross receipts or assets test (or failure to make the distribution earlier than when it was made) occurred in good faith. For example, if the corporation's qualified receipts subsequently were determined to be less than 95 percent of its total receipts as a result of a price adjustment made by the Internal Revenue Service (under sec. 482), or if the corporation received an unanticipated insurance recovery which caused its qualified receipts to be less than 95 percent of total receipts, the failure to satisfy the gross receipts test is to be considered due to reasonable cause.

The regulations are to provide that where the reasonable cause test is satisfied, a corporation may qualify as a DISC under this second rule, subject to two conditions. First, if the taxpayer believes in good faith that he had satisfied the gross receipts or assets test, the appropriate distribution generally must be made within 90 days from the time the Internal Revnue Service notifies the corporation it has not satisfied the gross receipts or gross assets test. This period may be extended by the Service if the Commissioner determines additional time is reasonable and necessary to permit the distribution to be made. In addition, the period for making the distribution is to be extended in any case where the corporation contests the determination of the Service in the courts.

The second requirement which must be met under this second distribution rule is that the corporation must pay a charge to the Service. This charge is intended to reflect the fact that the tax owing on the distribution (from the shareholder), in effect, has been deferred from the year in which the distribution should have been made until the year in which it actually is made. The amount of the charge is 4½ percent of the distribution times the number of taxable years that the distribution is delayed. (Since the charge is imposed on the entire amount of the distribution, this is the equivalent of a 9-percent rate if the distributions were taxable at 50 percent). For this purpose, the year with respect to which the distribution is made is not taken into account but the year in which it is made is taken into account. This charge is to be treated by the corporation as an interest payment. The payment must be made within 30 days of the time the distribution is made.

Ineligible corporations.—The Act excludes from DISC treatment various types of organizations where it would be inappropriate to combine the present treatment of the organization with DISC treatment. These ineligible organizations are tax-exempt organizations, personal holding companies, banks, savings and loan associations and other similar financial institutions, insurance companies, mutual funds, China Trade Act corporations and subchapter S corporations.

Coordination with personal holding company provisions in case of certain produced film rents.—The Act provides that a personal holding company is not eligible to be a DISC. Therefore, it is possible that if a film producer organized a subsidiary corporation to rent films produced by it, the subsidiary would not qualify as a DISC because the film rentals it received may be classified as personal holding company income. If the rentals had been received directly by the parent, the rentals generally would not be so classified. To prevent this inadvertent obstacle to the formation of DISC's when this type of income is involved, the Act provides that if a parent corporation organizes a subsidiary corporation for the purpose of qualifying the subsidiary as a DISC and transfers any interest it has in a film to the subsidiary, in effect, the film is to be treated in the hands of the subsidiary in the same manner as it would be treated in the hands of the parent company for purposes of the personal holding company provisions. The effect of this rule is to treat rents from films produced by the parent corporation and leased or rented by its subsidiary as not constituting personal holding company income if they are at least 50 percent of the subsidiary's income. If this is the case, the subsidiary will not be treated as a personal holding company and will not be ineligible for DISC treatment. This rule applies only if the parent owns directly 80 percent or more of the stock of the subsidiary throughout the taxable year in which the actual transfer of the film occurs.

4. Definitions and special rules (sec. 501 of the Act and sec. 993 of the code)

Qualified export receipts.—As previously discussed, for a corporation to qualify as a DISC, 95 percent of its gross receipts must consist of receipts which are considered to be export related—i.e., qualified export receipts. The Act specifies that the following are qualified export receipts—

(1) Receipts from the sale of export property. (As discussed subsequently, this generally means property such as inventory manufactured or produced in the United States which is sold for direct use, consumption or disposition outside the United States or to an unrelated DISC for such a purpose. Thus, a sale of property to an American manufacturer for incorporation in a product to be exported would not be considered for this purpose as an export sale.)

(2) Receipts from the leasing (including subleasing) or rental of export property for use by the lessee outside of the United States. (Whether leased property satisfies the usage test is to be determined on a year-by-year basis. Thus, the receipts on a lease of export property might qualify in some years and not in other years depending on the lessee's usage of the property in the years involved.) However, a *de minimis* use of the property in the United States is permissible.

(3) Receipts from services rendered in connection with a qualified export sale, lease or rental transaction if the services are re-

lated and subsidiary to the basic export transaction. In general, a service is related to a sale, lease or rental if it is of the type customarily and usually furnished with that type of transaction in the trade or business in which the transaction arose and the contract to furnish these services is connected with the sale, lease or rental. A service is subsidiary if it is of less importance and value as compared to the sale or lease. (Transportation services or services related to the installation or maintenance of export property would generally qualify as related and subsidiary to the sale, etc.) [1]

(4) Gains from the sale of qualified export assets (i.e., plant and equipment used in the corporation's export busines but not inventory).

(5) Dividends (and amounts considered as distributed under subpart F) from a related foreign export corporation (generally a foreign selling subsidiary of the corporation seeking to qualify as a DISC).

(6) Interest on obligations which are qualified export assets, such as accounts receivable arising in connection with qualified export sale, lease or rental transactions, producer's loans, and obligations issued, guaranteed, or insured by the Export-Import Bank.

(7) Receipts from engineering or architectural services on foreign construction projects which either are located abroad or proposed for location abroad. These services would include feasibility studies, and design, engineering and construction supervision. They would not include the provision of technical assistance or know-how or services connected with the exploration for oil.[2]

(8) Receipts for management services provided for other DISC's (in most cases a series of small DISC's) to aid those DISC's in deriving qualified export receipts. (These would include the various managerial, staffing, and operational services necessary to operate a DISC.)

To limit the application of the deferred tax treatment provided by the Act to situations which, in fact, involve export transactions, the Act provides that regulations may designate certain receipts as non-qualified export receipts. Receipts from five types of transactions, not really export transactions, are to be excluded from the category of qualified export receipts. These include, first, receipts arising from the sale or rental of property for ultimate use in the United States by itself or as a component of another article. Generally, property is to be considered sold or rented for ultimate use in the United States either if it is sold (or otherwise transferred) to a related person who

[1] For example, if a corporation sells a business machine which is export property and contracts to service the machine, the gross receipts from the services are qualified export receipts. However, if a corporation is engaged to render services and as an incidental part of the services sells export property, the gross receipts from the services are not qualified export receipts since such services are not subsidiary although they are related to such sale.

[2] Examples of services that qualify under this provision are architectural services in connection with the design of a building or civil engineering services in connection with the erection of a public project such as a bridge. The receipts derived from these services are qualified export receipts whether or not they are related and subsidiary to the sale of export property. If an engineering firm is engaged in a turn-key project or sole responsibility project performed abroad, the gross receipts derived from the engineering and architectural services are qualified export receipts. If the engineering firm also sells export property for installation in the project, the sale also produces qualified export receipts. However, the sale of foreign made goods does not generate qualified export receipts.

uses or resells the property (whether or not incorporated into other property) in the United States, or in the case of a sale to an unrelated person, if the sale is pursuant to an agreement or understanding that the property will be used in (or resold for use in) the United States or if a reasonable person would have known that the property would be used in (or resold for use in) the United States. For example, if property were sold to a foreign wholesaler and it was known in trade circles that the wholesaler, to a substantial extent, supplied the U.S. retail market, the sale would not be a qualified export sale.

A second category of excluded receipts are receipts from the sale of agricultural products under the P.L. 480 program and other United States Government programs designed to subsidize exports. For this purpose, programs designed to subsidize both domestic and foreign markets of the United States products (such as general price support programs) are not to be treated as a program designed to subsidize exports and therefore do not produce excluded receipts. A third category is receipts from direct or indirect sales, rentals, or services to the United States Government where the Government is required by law, regulation, or similar rule to purchase U.S. property or services. An example of an indirect sale to the United States Government resulting in a nonqualified receipt would be a sale of products to a foreign wholesaler who it is known in turn resells the products to the United States Army in the foreign country.

A fourth type of receipts which does not qualify are receipts from another member of the same controlled group of corportaions as the recipient corporation where the corporation involved is itself a DISC. A final category of nonqualified receipts is receipts arising from services provided in connection with any sale, lease or rental which itself is excluded in any of the above described categories.

For purposes of the DISC provisions, the term "controlled group" has the meaning given the term for purposes of multiple surtax exemptions (sec. 1563(a)), but with a 50-percent, rather than an 80-percent, ownership requirement. In addition, the limitations (of sec. 1563(b)) which would otherwise have excluded exempt organizations, foreign corporations, insurance companies, and franchise corporations from being within a controlled group are not to be applied.

Qualified export assets.—As previously indicated, 95 percent of a corporation's assets must be export related if the corporation wishes to qualify as a DISC. The types of assets classified as qualified export assets are—

(1) export property (i.e., inventory meeting certain tests described below);

(2) assets used primarily in connection with the sale, rental, storage, handling, transportation, packaging, assembly or servicing of export property or the performance of managerial, engineering or architectural services producing qualified export receipts;

(3) accounts receivable and evidences of indebtedness of the corporation (or if the corporation acts as agent, the principal) held by the corporation which arose in connection with qualified export sale, lease or rental transactions (including related and subsidiary services) or the performance of managerial, engineer-

ing, or architectural services producing qualified export receipts by the corporation;

(4) money and temporary investments, such as bank deposits reasonably needed for the working capital requirements of the corporation;

(5) obligations arising in connection with producer's loans (as defined below, generally loans of the DISC's profits to its parent company or other U.S. export manufacturer);

(6) stock or securities of a related foreign export corporation;

(7) obligations issued, guaranteed or insured (including reinsurance) by the Export-Import Bank or the Foreign Credit Insurance Association (such as, interest participation certificates and certificates of beneficial ownership) if the obligations are acquired from the Bank or Association or from the person selling or purchasing the goods or services giving rise to the obligations;

(8) obligations of a domestic corporation organized solely to finance sales of export property under an agreement with the Export-Import Bank, where the loans are guaranteed by that bank; and

(9) amounts deposited in banks at the end of its taxable year but which are in excess of the reasonable working capital needs of the corporation which are invested in qualified export assets within a specified period of time after the end of the taxable year.

Where a DISC performs packaging or assembly operations in connection with the export property which it sells, the facilities used for this purpose are to constitute qualified export assets if the operations represent packaging or assembly operations but not if they constitute manufacturing. Generally, if the property sold by the DISC is substantially transformed by it prior to sale, the property is to be treated as having been manufactured by the DISC. In addition, a DISC generally is to be considered as having manufactured property which it sells, if the operations performed by the DISC in connection with that property are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property. Operations performed by a DISC will be considered to be manufacturing if the value added to the product sold by reason of the operations of the DISC accounts for 20 percent or more of the total cost of goods sold.

As indicated above, bank deposits of a DISC which are in excess of its working capital needs are to be considered as qualified export assets if the funds are invested in other qualified export assets within a specified period of time. This provision is designed to allow a DISC some flexibility in its operations, for example, in the case where it receives a repayment of a producer's loan or a substantial income item in the latter part of its taxable year and does not have sufficient time in which to convert the amount into a qualified export asset prior to the end of the year. In such a case the regulations are to provide that the excess cash on hand at the end of the taxable year in the form of bank or similar deposits is to be considered a qualified export asset as of that time, if the following test is met: By the last day of the sixth, seventh, and eighth months after the end of the year, the DISC has increased the amount of its other types of qualified export assets to a level which is at least 95 percent of the amount of the total assets it held on the last day of that year. In other words, it is not required that there be a tracing of the excess bank deposits into specific qualified export assets. Rather, if by the last days of the three months mentioned, the level of the DISC's other types of qualified assets has increased to the point where the DISC would have satisfied the 95 percent assets tests, if it had held those assets on the last day of the taxable year in question, then the excess bank deposits are to be considered as qualified export assets on the last day of the year in question.

Export property.—Generally the principal function of a DISC will be the selling, leasing or renting of export property for use outside the United States. The type of property which is considered export property is property which—

(1) has been manufactured, produced, grown or extracted in the United States by someone other than a DISC;

(2) is held primarily for sale, lease, or rental in the ordinary course of business for use, consumption or disposition outside the United States, or which is held by the DISC for sale, lease or rental to another DISC for such a purpose; and

(3) not more than 50 percent of the fair market value of which is attributable to imported articles.

As discussed previously, a DISC may perform assembly operations in connection with the products which it sells. It may not, however, engage in manufacturing or construction activities with respect to those products. If the activities performed by a DISC in connection with the products represent the manufacture of property, then the products will not be considered export property and the gross receipts from the sale of the products will not be qualified receipts.

In determining whether property which is sold to another DISC is sold for direct use, consumption or disposition outside the United States, the fact that the purchasing DISC holds the property in inventory prior to the time it sells it for use, etc., outside the United States will not affect the characterization of the property as export property.

In determining whether a product has a sufficient amount of U.S. components so as to be eligible for classification as export property, any foreign components imported into the United States and incorporated in the product are to be taken into account at their fair market value upon importation (i.e., at what would be their full dutiable value in the absence of any special provisions in the tariff laws which result in a lower dutiable value). For example, the fact that imported foreign goods contain some U.S. components, which reduces the value upon which duty is assessed upon importation, is not to be taken into account in determining the amount of the value which the imported property contributes to the property which is to be exported. In other words, in these cases, even though the imported article has some U.S. content, it is to be treated as if it were 100-percent foreign content.

It is contemplated that the customs invoice on the importation of goods into the United States will be used in evidencing the value of the imported goods for purposes of this test. When a U.S. manufacturer sold goods with foreign components to a DISC, it would furnish a certificate to the DISC regarding the amount of the foreign content in the product which would be based on the information on the customs invoice forms.

Although the foreign content test generally is to be applied on an article-by-article basis, it would be permissible to apply the test on a mass account basis where the goods taken into account for this purpose are essentially identical.[3]

Where a category of property is not in sufficient supply to meet the demands of the domestic economy, even though it would be considered export property under the requirements discussed above, the Congress believed it would be inappropriate to make the tax deferral provided by the Act available. In such cases there is no reason to encourage exports. In view of this, the Act provides the President with authority to exclude from the category of export property any property which he determines is not in sufficient supply to meet the requirements of the domestic economy. If the President makes a determination of this nature by the issuance of an Executive Order, the property involved will not be treated as export property during the period for which the President determines and designates it to be in short supply.

The Act also contains a provision designed to prevent U.S. corporations from using a DISC to convert substantial amounts of what otherwise would be manufacturing or operational, as distinct from selling, income into tax deferred income. This could occur if property, which otherwise would be used outside of the United States in the parent's operations, were sold by the parent to a DISC subsidiary and then rented back from the DISC, since this would permit taxable operational profits to be converted into tax-deferred rental income. To prevent this result, the Act provides that any property leased to a corporation which is a member of the same group of controlled corporations as the DISC for its ultimate use is not to be considered export property in the hands of the DISC. For this purpose, it does not matter whether the related corporation leases the property directly from the DISC or indirectly from a lessee of the DISC. In either case, the property is not to be considered export property. Thus, if a DISC leases a movie film to a foreign corporation which is a member of the same group of controlled corporations and that foreign corporation then leases the film to persons not members of that group for showing to the general public, the film is not to be considered non-export property by reason of the lease from the DISC to the foreign corporation. However, if the persons showing the film to the general public are members of the same group of controlled corporations as the DISC, the film is not to be considered export property.

Finally, the Act provides that patents, inventions, models, designs, formulas, or processes, whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property are not export property. Although generally the sale or

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[3] Where identical components of domestic and foreign source are used interchangeably, the limitation on foreign content is to be applied on a substitution basis as in the case of the rules relating to drawback accounts under the customs laws. For example, assume that a manufacturer produces a total of 20,000 electronic devices, 10,000 of which are exported. Assume also that the major single component in each device is a tube which represents 60 percent of the value of the device. Assume further that the manufacturer imports 10,000 of these tubes and the remaining 10,000 were manufactured in the United States. In accordance with the substitution principle used in the customs drawback laws, each of the 10,000 exported devices is considered as containing a tube of foreign origin equal to 60 percent of its total value. As a result, since the 50 percent U.S. content requirement is not met, the exported goods are not export property.

license of a copyright does not produce qualified export receipts (since a copyright is generally not export property), the sale or lease of a copyrighted book, record, or other article does generally produce qualified export receipts.

Producer's loans.—As indicated previously, a DISC is permitted to loan its tax deferred profits back to its parent manufacturing company (or any other U.S. export manufacturing corporation), generally, as long as the cumulative amount loaned to any one borrower does not exceed the amount of the borrower's assets considered as being related to its export sales. This in essence is the same proportion of the borrower's assets that its export sales are of its total sales. These loans—termed "producer's loans"—are to constitute qualified export assets of a DISC and the interest arising on the loans is to represent a qualified export receipt of a DISC.

For a loan of a DISC's tax deferred profits to constitute a producer's loan, the loan must be made to a borrower who is engaged in the manufacturing, production, growing, or extraction of export property in the United States and at the time the loan is made it must be designated as a producer's loan. In addition, the loan must be evidenced by a note (or some other evidence of indebtedness) and must have a stated maturity date of not more than 5 years. If a loan which qualifies as a producer's loan is not collected by the DISC when it matures, it must requalify as a producer's loan as of the maturity date. If a producer's loan is extended at maturity for a period which does not have a fixed time limit, the loan is to cease to qualify as a producer's loan at its original maturity.

To qualify as a producer's loan, a loan must be made out of the DISC's tax deferred profits—its accumulated DISC income. A loan is to be considered as made out of accumulated DISC income if at the beginning of the month in which the loan is made, the amount of the loan, when added to the unpaid balance of all other producer's loans previously made by the DISC, does not exceed the DISC's accumulated DISC income.

As indicated above, a limitation is placed on the amount of a DISC's tax deferred profits which may be loaned to any one borrower, which in general is the amount of the borrower's assets treated as export related. To the extent a loan exceeds the borrower's limitation, it is not to be considered a producer's loan. Whether a loan of a DISC's tax deferred profits to a borrower is within the borrower's limitation is to be tested at the time the loan is made by adding the amount of the loan to the unpaid balance of all other producer's loans of the borrower outstanding at that time and comparing this amount to the borrower's limitation.

The limitation imposed on the amount of loans which a borrower may receive during a taxable year of the borrower is to be determined by applying the percentage, which the borrower's export receipts arising from its sale of export property (through a DISC or otherwise) during the three prior taxable years is of its aggregate gross receipts from the sale of inventory property during that period, to the total of the borrower's assets taken into account for this purpose. In no event, however, are the receipts of a taxable year beginning before 1972 to be taken into account in determining this percentage.

There are three categories of a borrower's assets which are taken into account in determining this limitation for a year: (1) the amount of the borrower's investment in plant, machinery, equipment and supporting production facilities in the United States as of the beginning of its taxable year (taken into account at its adjusted basis at that time); (2) the amount of the borrower's inventory at the beginning of the taxable year (taken into account in the manner in which the borrower normally values its inventory); and (3) the aggregate of the borrower's research and experimental expenditures in the United States during all preceding years of the borrower which began after 1971.

In addition to the requirements discussed above, a loan can qualify as a producer's loan only to the extent that the DISC is able to show that at the end of the year of the loan the borrower increased its inventory, plant, machinery, and equipment, and research and development expenditures in the United States for that year by an amount equal to the loan.

If a loan of a DISC's accumulated DISC income qualifies as a producer's loan under the requirements and limitations described above at the time when the loan is initially made, it is to remain a producer's loan until its maturity. If at its maturity the borrower's limitation is sufficient to permit a new loan in the amount of the old loan, then the old producer's loan could be renewed for an additional stated period of up to 5 years and then would qualify as a producer's loan for that period. The fact that a borrower's allowable level of producer's loans decreases after the time it received a particular producer's loan does not affect the qualified status of that loan. On the other hand, a loan which does not qualify as a producer's loan at the time it is made does not subsequently become a producer's loan by reason of an increase in the borrower's limitation.

Where a borrower is a member of a controlled group of corporations, the limitation may be determined at the borrower's election by taking into account the export sales and export-related assets of the group of corporations (other than any member of the group which is a DISC).

A separate limitation from that described above may be used in the case of a borrower who is a domestic film maker. In order for a loan to be considered a producer's loan under this rule in the case of a domestic film maker with respect to a film, the studio used for filming and for recording sound must be located in the United States, at least 80 percent of the aggregate playing time of the film must be photographed within the United States, and at least 80 percent of the total amount paid for services performed in the making of the film must be paid to persons who are U.S. persons at the time they perform the services (or consists of amounts which are fully taxable by the United States). Since whether a loan qualifies must be determined at the time the loan is made, the 80-percent-of-amount-paid requirement does not include any amount contingent upon receipts or profits of the film if the amounts are fully taxable by the United States because these items are unpredictable at that time. An amount is considered fully taxable if the entire amount is included in gross income. Where a nonresident alien individual or corporation is engaged to furnish the services of one of its officers or employees in the making of the film, the amount paid may be counted toward the 80-percent test if it is fully taxable by the United States and not exempt from taxation under any provision of law or treaty.

This limitation on the amount of the loan is to be determined by taking into account the domestic film maker's current plant and equipment, inventory, the research and development expenditures plus any assets of this type which will be acquired at any time by the film maker with respect to films commenced during the year in which the loan is made. The portion of these assets which are considered export-related (which is the limit on the amount of the producer's loan which may be made) is to be determined by reference to the export experience of other producers of similar films. It is anticipated that industry statistics will be used for determining the relevant experience of other producers in this regard.

Related foreign export corporations.—To take account of the fact that a DISC may find it helpful or even necessary in conducting its exporting business to have certain types of foreign investments, the Act provides that a DISC is to be permitted to own stock or securities in three types of foreign corporations. In other words, stock or securities of this type are to be qualified export assets and the dividends or interest arising on the investment are to be qualified export receipts.

The three types of foreign corporations in which a DISC may own stock or securities are—

(1) a foreign international sales corporation (or FISC), which in essence is a foreign selling arm of the DISC principally engaged in marketing export property;

(2) a real property holding company, which in general is a foreign company that holds title to real property used by the DISC which the DISC cannot own directly because of the requirements of the applicable foreign law: and

(3) an associated foreign corporation, which generally is a foreign customer of the DISC in which it must invest as a means of extending to the customer the export credit which is needed to effect the export sale or sales.

For a foreign corporation to qualify as a FISC, more than 50 percent of its voting power must be directly owned by the DISC and 95 percent of its gross receipts and assets must be related to U.S. exports. For this purpose, the foreign corporation's U.S. export-related receipts consist only of its gross receipts from qualified export sale, lease, or rental transactions and related and subsidiary services, and receipts from the sale of other qualified export assets. The corporation's export-related assets consist only of its inventory of export property, its facilities for the sale, lease, rental, assembly, etc., of export property, its accounts receivable which arise by reason of qualified export sales, leases, rentals, or related and subsidiary services, and its working capital related to its export business and represented by money, bank deposits, and other similar investments.

A real property holding company is a foreign corporation in which a DISC directly owns more than 50 percent of the voting power and the exclusive function of which is to hold real property for the exclusive use of the DISC. The real property may be used by the DISC under a lease or other type of arrangement.

For a foreign corporation to qualify as an associated foreign corporation, the DISC's ownership of stock or securities in the foreign corporation must be reasonably in furtherance of transactions which produce qualified export receipts for the DISC (as determined under regulations prescribed by the Secretary of the Treasury).[4] In addition, for a foreign corporation to qualify as an associated foreign corporation, the portion of its voting power which is owned either by the DISC or by a controlled group of corporations which includes the DISC must be less than 10 percent. In determining the amount of voting power in the foreign corporation which is owned by the DISC or controlled group for this purpose, the attribution rules of section 1563 (d) and (e) are to apply.

Gross receipts.—The Act provides that the term gross receipts means in the case of sales, leases or rentals of inventory, the total receipts arising on the sale, lease or rental. In the case of other types of transactions, gross receipts is to include only the gross income arising on the transaction. For example, in the case of a sale by a DISC of an export-related asset (other than inventory) the gross receipts arising on the sale would be the gain realized.

To make the treatment of sales (leases or rentals) which the DISC makes on a commission basis comparable to the treatment of sales (leases or rentals) by the DISC of property which it has purchased, it is provided that in the case of a commission sale, the DISC's gross receipts are to be the gross receipts on the sale (lease or rental) of the property to which the commission relates, rather than just the amount of the commission. The time when the receipts on a commission sale (lease or rental) arise is to be determined under the commission arrangement and the accounting method otherwise employed by the DISC. For example, in the case of a deferred payment sale, if under the DISC's accounting method it would be considered as having received the entire commission in the year of sale, then the entire amount of gross receipts to which the commission relates is to be considered as received in that year, even though actual payment is not made until subsequent years. On the other hand, if under the DISC's method of accounting, it would be considered as having received the commission only as the payments for the property sold were received in future years, then the gross receipts on the sale are to be considered as received in each subsequent year to the extent they relate to the commission which the DISC is considered as receiving in that year.

United States defined.—The Act provides that for purposes of the new DISC provisions, the term United States is to include possessions of the United States. In other words, for this purpose, the United States includes Puerto Rico, America Samoa, Guam, and the Virgin Islands. As a result, property "exported" to U.S. possessions is not to be considered as export property and a related foreign export corporation may not be organized in a possession. On the other hand, property imported into the United States from a U.S. possession, which is subsequently incorporated in property to be exported, is not to be considered a foreign item in determining the foreign content of the property exported.[5]

[4] Generally, this ownership will be considered as being in furtherance of transactions giving rise to a qualified export receipt if the ownership is necessary to maintain or obtain a customer or is to aid the sales distribution system of the domestc corporation. However, the investment in the foreign corporation must be reasonable in amount as compared to the value of the business which can be expected to be derived due to such ownership.

[5] Since a DISC must be organized under the laws of a State, a corporation is not a DISC for purposes of U.S. taxes if it is organized under the laws of a possession.

5. Intercompany pricing rules (sec. 501 of the Act and sec. 994 of the code)

Under the intercompany pricing rules of present law, a sale to a related person generally must be made on an arm's length basis (i.e., the price charged the related person must be essentially the same as that which would be charged an unrelated third person). The Congress believes it is desirable to avoid the complexities of the present pricing rules in the case of sales by a domestic parent corporation (or other entity considered related under section 482) to a DISC and also to provide encouragement for the operation of DISC's. In view of this, the Congress has provided two pricing rules which may be used in determining the permissible profits—although in excess of profit under arm's length rules and regardless of the sales price actually charged—which a DISC may earn on products which it purchases from a related company and then resells for export. Of course, in any case where the arm's length pricing rule would allow a greater allocation of profit to the DISC than would the new rules, that rule will continue to be applicable.

Under the first of the two new rules, a DISC may earn that portion of the combined taxable income arising on the sale by a DISC of export property purchased from a related person which does not exceed 4 percent of the qualified export receipts from the sale, plus 10 percent of the DISC's export promotion expenses attributable to the sale. Income may not, however, be allocated to the DISC under this (or the second) rule to the extent it would result in the related person who sold the products to the DISC incurring a loss on the sale.[6]

Under the second pricing rule provided by the Act, a DISC may earn up to 50 percent of the combined taxable income of the DISC and the related person arising from the sale of the property plus an additional amount equal to 10 percent of the DISC's export promotion expenses attributable to the sale. For this rule, the combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country. These rules generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis. Thus, the combined taxable income of a DISC and a related person with respect to the sale by the DISC of export property would be determined by deducting from the DISC's gross receipts the related person's cost of goods sold with respect to the property, the selling, overhead and administrative expenses of both the DISC and the related person which are directly related to the production or sale of the export property and a portion of the related person's and the DISC's expenses not allocable to any specific item of income, such portion to

[6] The pricing rule described above can be illustrated by a DISC which sold export property it purchased from a related person for $100, and incurred export promotion expenses attributable to that sale of $10. In this case, there could be allocated to the DISC that part of the combined taxable income arising with respect to the export property which did not exceed $5 (4 percent of $100 plus 10 percent of $10). This profit element of $5 plus the promotion expenses of $10 indicates that the transfer price of the related person to the DISC in this case could be $85 ($100 less the $10 of promotion expenses and the $5 of DISC profit). If the combined taxable income arising on the sale (i.e., the receipts of the DISC on the sale less the parent's cost of goods sold for the property and the applicable other expenses of the parent company and the DISC) were only $4, then the amount of profit allocated to the DISC on the sale may not exceed $4.

be determined on the basis of the ratio of the combined gross income from the export property to the total gross income of the related person and the DISC.[7]

Although both of the pricing rules provided by the Act generally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines.

Where a DISC is attempting to establish a market abroad, or seeking to maintain a market abroad, for exports, the Secretary of the Treasury may prescribe by regulations special rules governing the allocation of expenses incurred on the sale of the export property for purposes of determining the combined taxable income of the related person and the DISC. It is expected that in the appropriate cases the regulations will allow, for purposes of applying the second pricing rule, the combined taxable income on the sale of export property to reflect a profit equal to that which the DISC and a related party would earn if they took into account only the marginal costs of producing the property. The production expenses not considered marginal costs in this case would, of course, be allocable to the production of the related party which is not sold to the DISC.

These rules do not apply to sales to a DISC by a person who is not a related person (within the meaning of sec. 482), nor do they apply to sales by a DISC to another person. As a result, sales by a DISC to a foreign person will be subject to the regular pricing rules (sec. 482). This will insure that income is not diverted to foreign subsidiaries by underpricing on sales by a DISC to foreign affiliates.

The Act also provides that the Secretary of the Treasury may prescribe by regulations intercompany pricing rules, consistent with those provided by the Act, in the case of export transactions where the DISC does not take title to the property, but instead, acts as commission agent for the sale, or is a lessee of the property which it then subleases to its customers.

In the situation where minerals of a taxpayer are sold by a related DISC on a commission basis, it is believed that to effectuate the purpose of the DISC provisions of the Act, the taxpayer should not be placed in any different position than if it had directly made the sale for purposes of determining its "taxable income from the property" for percentage depletion purposes. In other words it is intended that in this case the Treasury Department under its broad regulatory authority in this area will provide that the taxpayer is not required to deduct the amount of the commissions paid to the DISC to the extent they exceed the selling expenses of the DISC. Actual or deemed distributions from a DISC, however, are not to be considered "taxable income from the property."

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[7] For example, assume the DISC's selling price was $1,000, the cost of goods sold of the related person $650, the directly related selling and administrative expenses $150, including $90 of export promotion expenses incurred by the DISC, and indirect expenses prorated to the export income of $30 (assuming total unallocable expenses of $300, $3,500 total gross income of the related person and the DISC (excluding the transfer price paid by the DISC) and $350 of combined gross income from the export property ($1,000 gross receipts less $650 cost of goods sold), so that $300×$350/$3,500=$30). This indicates a combined taxable income of $170 ($1,000 less $650 and $180). In this case, the DISC would be allowed a taxable income of $94 (50 percent of the combined taxable income of $170 or $85 plus $9, representing 10 percent of the export promotion expenses it incurred). Accordingly, the related person would be allowed a taxable income of $76. This represents one-half of the profit of $170 less the $9 allocated to the DISC because of its export promotion expenses. This indicates that the related person could charge a transfer price to the DISC of $816 ($650, cost of goods sold; $60, selling and administrative expenses; $30, indirect expenses; and $76, taxable income). The DISC would realize a gross profit of $184 and after deduction of the $90 export promotion expenses, a taxable income of $94.

As indicated above, a DISC under either of the pricing rules may earn additional profit on the sale of export property purchased from a related person equal to 10 percent of the DISC export promotion expenses attributable to the sale. This rule is designed to encourage the transfer of a greater amount of selling functions and activities to DISC's. For purposes of this rule, export promotion expenses include 50 percent of the freight expenses (not including insurance) for shipping export property aboard airplanes owned and operated by U.S. persons or U.S.-flag vessels except that these expenses may not include any incurred where law or regulation require that the export property be shipped aboard such airplanes or vessels. Export promotion expenses also include a DISC's ordinary and necessary expenses paid or incurred to obtain the qualified export receipts. These expenses include advertising, salaries, rentals, sales commissions, warehousing and other selling expenses. They do not, however, include income taxes or any expenses which do not further the distribution or sale of export property for use or consumption abroad.

6. Taxation of DISC income to shareholders (sec. 501 of the Act and sec. 995 of the code)

This provision deals with the basic rules for taxing the shareholders of a DISC. In general, it provides that shareholders are to be taxed on the income of the DISC when it is actually distributed. There are also three situations in which a DISC shareholder will be taxed on DISC income even though the income is not actually distributed.

The first situation in which a DISC shareholder will be treated as having DISC income occurs when certain amounts are deemed distributed in qualified years. There are five categories of income which are deemed to be distributed even though a valid DISC election is in effect. Three of these categories involve situations in which a DISC receives income which does not arise from export activities. These are interest derived from producer's loans, gain recognized by a DISC on property (which is not a qualified export asset) transferred to it in a transaction in which gain was not recognized, and gain recognized by a DISC on depreciable property (whether or not it is a qualified export asset) transferred to it in a transaction in which gain was not recognized. The fourth type of deemed distribution during a qualified year relates to that portion of the DISC's taxable income which, pursuant to the Congress' decision to allow deferral on only one-half of the DISC's earnings, is deemed distributed to shareholders. The shareholders of a DISC are, generally speaking, deemed to have received one-half of the excess of a DISC's taxable income over the amounts which are deemed distributed pursuant to the other deemed distribution rules. The fifth type of deemed distribution during a qualified year is the amount of foreign investment attributable to producer's loans of a DISC. This category was added because of the possibility that amounts loaned to a U.S. parent (or affiliate) by a DISC, as a producer's loan, would be used for foreign investment. The amount of foreign investment which is, under the Act, attributable to producer's loans, is to reduce the amount of DISC profits eligible for deferral.

Treating these types of income as deemed distributions has the effect of denying them tax deferral treatment. This is appropriate since the income either is not export related or is attributable to that portion of a DISC's earnings with respect to which it is not appropriate to allow deferral.

The second situation in which a deemed distribution arises is where a corporation no longer qualifies as a DISC—because the corporation terminates its election or fails to meet the qualification requirements with respect to any year. In these cases, the DISC income on which tax has previously been deferred is deemed distributed, generally in equal installments over 10 years (or such shorter period of time as the corporation was a DISC). The intent of this is to terminate tax deferral when a corporation no longer qualifies as a DISC.

There is a third situation in which income is taxed to the shareholders of a DISC. This occurs when a shareholder disposes of stock in a corporation with tax deferred DISC income. Under usual rules he would be treated as having a capital gain in such a case to the extent the amount he receives exceeds his cost or other basis in the stock. However, in this case, since the tax on the DISC income has been deferred, the value of the stock at the time of sale reflects this tax deferred income. To prevent this tax deferred income from being converted into capital gain in these cases, the Act provides that this gain is to be classified as ordinary income to the extent of the tax deferred DISC income attributable to the stock. Similarly, where stock in a corporation which is, or was, a DISC is disposed of in a transaction in which the existence of the corporation is terminated, gain is to be recognized (even though it would otherwise be tax free) and the gain is to be ordinary income to the extent of the tax deferred DISC income attributable to the stock.

General rule.—The income of a DISC is to be taxed to its shareholders when it is actually distributed, deemed distributed, or in effect realized by a shareholder through a transaction such as a sale of his stock at a gain which reflects the accumulated income.

Deemed distributions in qualified years.—Although the Act generally provides for the deferral of tax on the profits of a DISC until an actual distribution is made, in the case of five categories of income received by a DISC, tax is imposed currently. The current taxation is accomplished, however, not by taxing the income to the DISC but rather by taxing it to the shareholders of the DISC as if the income had been distributed to them. These deemed distributions for a year, however, are not to exceed the DISC's earnings and profits for the year (except in the case of foreign investment attributable to producer's loans). When amounts which are deemed distributed to a DISC's shareholders are actually distributed to them, the actual distributions are to be tax free.

First, each shareholder of a DISC is deemed to receive an annual distribution equal to his pro rata share (based upon his ownership of DISC stock) of the gross interest income received by the DISC on its producer's loans.

Second, the shareholders of a DISC are deemed to have received a pro rata distribution upon the sale by the DISC of property (which is not a qualified export asset in its hands) transfered to it in a tax-free exchange. The amount deemed distributed is not, however, to exceed the transferor's gain not recognized on the previous transfer to the DISC. This rule is designed to prevent the transfer of appreciated property, which would not be an export asset to the DISC (e.g., stock or securities in a corporation other than a related foreign export corporation), to be followed by the sale by the DISC of the transferred property. Without a rule of this type, the DISC would not be taxed on the gain arising from the sale, even though it may have been considered to be a nonqualified export receipt.

Third, a DISC's shareholders are to be deemed to have received a pro rata distribution upon the sale by the DISC of depreciable or other property (other than inventory) which it received in a tax-free transaction. The distribution in this case is equal to the amount of the gain realized by the DISC, but only to the extent there would have been ordinary income if the property had been sold by the person who transferred it to the DISC at the time of the transfer. This rule basically is designed to prevent the transfer of depreciable property to a DISC in a transaction in which gain is not recognized followed by the sale by the DISC of the property. In the absence of this rule, the DISC would not be taxed on the sale and the depreciation recapture effect (as provided for in sections 1245 and 1250), which would give rise to ordinary income treatment if the sale had been made by the transferor, would be avoided.

These latter deemed distribution rules are to apply where property is contributed to a DISC as a contribution to capital and also in the case of nonrecognition exchanges.[8] In addition, if a transferor recognizes any gain as the result of the transfer of property to a DISC (due, for example, to the receipt of "boot" in a section 351 exchange), that recognized gain is to be taken into consideration in determining the amount of the deemed distribution resulting from the sale by the DISC of the transferred property.[9]

Fourth, in accordance with the provision allowing deferral on only one-half of a DISC's taxable income, the DISC shareholders are to be deemed to receive the excess of one-half of the taxable income of the DISC over the amounts deemed distributed to shareholders under the other rules providing for deemed distributions. Assume, for example, that a DISC has taxable income during the year of $500. During this same period it also receives interest on producer's loans in the amount of $25 and realizes a $25 gain on property transferred to it in a nonrecognition exchange which is treated as a deemed distribution. In that year, assuming no other facts, the DISC shareholders would be deemed to have received a distribution equal to one-half of the excess of $500 over the amounts ($50) otherwise deemed distributed. This would result in a deemed distribution to the DISC's shareholders of $225 (in addition to the $50 otherwise deemed distributed). Thus, $225 of the DISC's income would be eligible for deferral.

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[8] For example, assume a U.S. corporation acquires data processing equipment at an original cost of $150,000. Assume the corporation transfers the equipment to its wholly owned DISC, as a contribution to capital, when the adjusted basis of the equipment is $110,000 and its fair market value is $130,000. Assume further that the DISC is entitled to depreciation deductions of $40,000. At the end of a 2-year period, the DISC sells the equipment for $120,000 and as a result realizes a gain of $50,000 ($120,000 less $70,000). If the equipment had been sold by the parent at a time of the transfer, instead of transferred to the DISC, it would have realized $20,000 ordinary income pursuant to the depreciation recapture rules (sec. 1245). Accordingly, $20,000 of the $50,000 gain realized by the DISC on the sale of the equipment is to be treated as a deemed distribution to the parent.

[9] For example, if section 1245 property (with respect to which depreciation in the amount of $20 has been taken) with an adjusted basis to the transferor of $80 and a fair markt value of $100 is transferred to a DISC in return for stock and "boot" in the amount of $10, the subsequent sale of the transferred property by the DISC for $105 will result in a realized gain to the DISC of $15 (assuming it took no depreciation deductions with respect to the property) of which $10 will be considered a deemed distribution.

Fifth, the DISC shareholders are to be deemed to receive the amount of foreign investment attributable to producer's loans. The amount of foreign investment attributable to producer's loans is, generally, the amount of the net increase in foreign assets made by members of the same controlled group as the DISC, but in no event more than the lesser of the actual amount of funds transferred abroad by domestic members of the controlled group, or the outstanding amount of producer's loans.

Assume, for example, that during a year, there was a net increase in foreign assets by members of the same controlled group as a DISC, in the amount of $300. Assume further that the actual amount of funds transferred abroad by the domestic members of the group was $125 and the outstanding amount of the producer's loans was $75. The amount of foreign investment in this case attributable to producer's loans is limited to the smallest of the $300 net increase in foreign assets, the actual foreign investment by domestic members ($125) or the total amount of producer's loans ($75). Therefore, the amount of foreign investment attributable to producer's loans is $75. Consequently, this additional amount would be considered a deemed distribution to the DISC's shareholders.

As indicated subsequently, deemed distributions in qualified years are not to be eligible for the dividends received deduction since the income will not have been taxed to the DISC. These deemed distributions to a DISC's shareholders are to be treated as received by the shareholders on the last day of the taxable year of the DISC in which the income in question was derived (according to the DISC's method of accounting).

Deemed distributions upon termination or disqualification.—The deferral of tax on a DISC's income continues as long as the corporation is a DISC. However, when the corporation terminates its DISC election or fails to qualify as a DISC, its accumulated DISC income (its earnings and profits accumulated while it was a DISC) is to be deemed distributed pro rata to its shareholders.

Following termination or disqualification each shareholder is deemed to receive a distribution equal to his pro rata share of the DISC income of the corporation accumulated during the immediately preceding consecutive years for which the corporation was a DISC.

To avoid the taxation in one year of income accumulated over a period of years, the Act provides that amounts deemed distributed to the shareholders of a DISC which terminates its election or disqualifies are to be treated as received in equal installments over a 10-year period beginning with the year following the year of termination or disqualification. If the number of consecutive years during which the corporation qualified as a DISC immediately prior to the termination or disqualification was less than 10, then the deemed distributions are to be treated as received over that smaller number of years. These deemed distributions are considered received by the shareholders on the last day of the corporation's taxable year in which they are deemed made. For example, if a corporation qualifies as a DISC for the taxable years 1972 through 1975, but disqualifies in 1976, its shareholders are to treat their deemed distribution as received in equal installments on the last day of the 4 taxable years of the corporation beginning with the year 1977.

Deemed distributions upon termination or disqualification are to continue and are to be included in income by the shareholders even though the corporation subsequently requalifies as a DISC. For example, if the corporation in the above illustration requalifies as a DISC for the calendar year 1977, this is not to affect the deemed distributions occurring as a result of the prior termination or disqualification.

If during the period the DISC income is being deemed distributed, an actual distribution of that DISC income is made, it is to first reduce the last installment of the deemed distributions, and then the preceding installments in reverse order.[10] If deemed distributions are being received for two or more disqualifications, an actual distribution affects the deemed distribution resulting from the earlier disqualification first.

Deemed distributions resulting from disqualifications or termination are includible in a shareholder's income only while he continues to hold stock in the corporation. In other words, if the shareholder disposes of his stock, the distributions after the disposition will be deemed received by the shareholder's successor in interest, rather than the selling shareholder. As discussed subsequently, the disposition itself may result in the taxation of the DISC income to the shareholder and also render future deemed distributions to his successor in interest nontaxable.

Gain on the disposition of DISC stock.—The Act provides that when stock in a DISC (or former DISC) is disposed of in either of two types of transactions, the disposing shareholder is to be taxed as if he received a dividend on his share of the accumulated DISC income, generally to the extent of the gain realized on the disposition. The amount attributable to the DISC income is to be treated as a dividend.

The first type of transaction covered by this provision is one in which the shareholder disposes of his stock in a DISC (or former DISC) where gain is recognized. The second type is a nonrecognition of gain transaction (such as a parent-subsidiary liquidation) in which the DISC (or former DISC) ceases to exist as a separate corporate entity. In these cases, the shareholder of the DISC, by realizing gain on the disposition of his stock in an amount which reflects the accumulated DISC income is, in effect, in much the same position as if he had actually received that income.

The first type of transaction—disposition of stock where gain is recognized—includes, of course, the sale of stock of a DISC (or former DISC). In such a case, the gain realized by the seller is to be treated as a dividend to the extent of the corporation's accumulated DISC income attributable to the stock sold. Thus, if a shareholder, whose share of the corporation's accumulated DISC income is $30, sells his DISC stock, which has a basis of $50, for $100, $30 of the realized gain of $50 is to be treated as ordinary income. If the stock had been sold for $70, the entire realized gain of $20 would be treated

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[10] For example, assume that as a result of the disqualification of a DISC in 1976 after four years of qualification, a shareholder is to be deemed to receive $5,000 in each of the four succeeding taxable years (1977, 1978, 1979 and 1980). If the shareholder receives a $6,000 actual distribution during 1977 out of DISC income accumulated during the consecutive years immediately prior to the disqualification, the distribution is to be treated as follows. First, it is to eliminate the 1980 deemed distribution and then it is to reduce the 1979 deemed distribution to $4,000. Thus, in 1977, the shareholders will include $11,000 in gross income (the $5,000 deemed distribution for 1977 and the $6,000 actual distribution). In 1978, the shareholder will be taxed on the $5,000 deemed distribution for that year, and in 1979 will be taxed on the final deemed distribution of $4,000.

as ordinary income. Only the amount of DISC income which was accumulated during the period or periods during which the selling shareholder held the DISC stock is to be taxed as a dividend upon disposition of the DISC stock. Insofar as the year of sale is concerned, it is intended that the DISC income for the year, although determined at the close of the DISC's taxable year, is to be prorated over the year and only that portion attributable to the period prior to the disposition is to be taken into account in determining the amount attributable to the shares disposed of.

Gifts during lifetime of DISC stock or transfers by reason of death of DISC stock are not to result in ordinary income treatment to the transferor since there is no gain realized on the disposition. On the other hand, gain on the redemption of a shareholder's stock by a DISC (e.g., one that is in complete termination of the shareholder's interest or one that is substantially disproportionate) is to be treated as ordinary income (rather than capital gain) to the extent of the DISC income attributable to the shares redeemed. Transactions which produce partial recognition, such as the transfer of DISC stock to a corporation in exchange for stock and "boot," also are within this category. In this case, the gain recognized as a result of the receipt of "boot" is to be treated as ordinary income to the extent of the DISC income attributable to the transferred DISC stock.

Among the transactions within the second type which result in ordinary income to the shareholders of a DISC are "A" or "C" reorganizations where the DISC ceases to exist as a separate entity. For example, if a corporation acquires the assets of a DISC in an "A" or "C" reorganization and the shareholders of the DISC exchange their stock for stock of the acquiring corporation (with the DISC ceasing to exist as a separate entity), the gain realized on the transaction by the DISC shareholders is to be recognized and taxed as ordinary income (notwithstanding the nonrecognition treatment otherwise accorded to these transactions) to the extent of the accumulated DISC income attributable to their stock. The liquidation of a DISC subsidiary is another example of a transaction which falls within the second type of transactions which results in ordinary income treatment. Thus, if a parent corporation liquidates its wholly owned DISC (which would normally be entitled to nonrecognition under section 332), gain is to be recognized and treated as ordinary income to the extent of the subsidiary's accumulated DISC income.

A "B" reorganization, on the other hand, usually will not be within the second category since the DISC usually will remain in existence. Accordingly, the shareholders of a DISC who exchange their stock for the stock of an acquiring corporation in a "B" reorganization would be entitled to the generally applicable nonrecognition of gain treatment. The acquiring corporation would step into the shoes of the previous DISC shareholders and the DISC (the acquired corporation) would maintain its status as a DISC.

There are other types of corporate adjustments generally accorded nonrecognition treatment in which the DISC will survive and thus will not have ordinary income tax consequences for the DISC shareholders. For example, assume a DISC is "split-up" into two corporate entities, in a manner which would be treated as a tax-free reorganization. Since the DISC survives (although as two separate DISC's), the shareholders of the DISC who exchange their stock for stock in one of the two surviving corporations (each of which will qualify as a DISC) will not, as a result of the split-up, be treated as having ordinary income by reason of the DISC rules. The accumulated DISC income of the DISC, and other attributes, will be allocated among the surviving corporations in accordance with regulations promulgated by the Treasury. In addition, it is provided that a mere change in a DISC's place of incorporation (which would constitute a tax-free "F" reorganization) is not to be considered as terminating the DISC's existence and thus is not to have ordinary income tax consequences for the DISC's shareholders. The newly incorporated DISC would step into the shoes of the DISC incorporated in the other jurisdiction.

The ordinary income treatment provided by the Act on the disposition of stock in a DISC is intended to apply only to the extent that the recognized gain is not, under another provision of the code, treated as a dividend or as a gain from the sale of an asset which is not a capital asset. For example, assume that a shareholder of a DISC exchanges his stock in a "C" reorganization for stock of the acquiring corporation and receives "boot" which causes a portion of the shareholder's gain to be treated as a dividend (under the "boot dividend" rule of section 356(a)(2)). The ordinary income treatment is to apply to the shareholder's gain on the exchange of his stock only to the extent the gain realized exceeds the amount treated as a dividend under the "boot dividend" rule.

Determination of foreign investment attributable to producer's loans.—As previously stated, the Act provides that the amount of foreign investment attributable to producer's loans, in addition to the other specified amounts, is to be deemed distributed to a DISC's shareholders and thus currently subject to taxation. This has the effect of reducing below one-half the amount which will be eligible for deferral under the Act's general provision.

Three steps are involved in determining the amount of foreign investment attributable to producer's loans. Under regulations prescribed by the Treasury, the determinations required to be made are to be cumulative in nature (generally for the period after December 31, 1971) but with proper adjustments for amounts previously taken into account. First, it is necessary to compute the amount of the net increase in foreign assets which are made by members of the same controlled group as the DISC (including foreign members). An increase in foreign assets is the amount equal to the amount incurred to acquire assets (located outside the United States) described in section 1231(b), which, generally speaking, includes depreciable property and real property used in a trade or business. For this purpose, assets constituting qualified export assets in the hands of a DISC (or assets which would be qualified export assets if held by a DISC) are not to be taken into account. Thus, for example, if a capital contribution results in the acquisition by a DISC of qualified export assets which are located outside the United States, these assets are not to be considered in determining the increase in foreign assets. Under regulations prescribed by the Treasury, the acquisition of a majority interest in the stock of a foreign corporation may be considered the acquisition of the business assets held by the foreign corporation.

After the gross increase in foreign assets is determined, it is necessary to reduce this amount to a net basis by subtracting five items. This is because the foreign assets are, to the extent of these items, considered as first acquired with funds from these sources. The first item is the depreciation with respect to the foreign assets of the group. The second item is equity capital and borrowings raised abroad. Thus, amounts derived by members of the controlled group (including foreign members) from the sale of stock or debt obligations of these corporations which are acquired by non-United States persons (other than members of the group) are also to be taken into account to determine the "net" increase in foreign investment. The third item is one-half of the earnings and profits derived by foreign members of the group and by foreign branches of domestic corporations which are members of the controlled group. The fourth item is one-half of the royalties and fees which are paid by foreign members of the group to domestic members of the group. The fifth item is the uncommitted transitional funds of the group. The Act defines uncommitted transitional funds as consisting of the sum of two amounts. The first part is the excess of the amount of stock or debt obligations issued by domestic members of the group on or after January 1, 1968, to unaffiliated foreign persons and outstanding on December 31, 1971, over the net amount of funds transferred by domestic members of the group to foreign members of the group (or foreign branches of domestic members) during the period the stock or debt was outstanding. This excess amount may be taken into account, however, only to the extent the taxpayer establishes that the foreign borrowing (i.e. the issuance of the stock or debt obligations) constitutes a long-term foreign borrowing for purposes of the foreign direct investment program administered by the Office of Foreign Direct Investment of the Department of Commerce. It is intended that a taxpayer ordinarily should establish that a foreign borrowing constitutes a qualified long-term foreign borrowing for this purpose by demonstrating that appropriate reports were filed with the Office of Foreign Direct Investment with respect to the foreign borrowing. The second part of uncommitted transitional funds consists of the amount of liquid assets held by foreign members of the group (and foreign branches of domestic members) on October 31, 1971, in excess of the reasonable working capital needs of such foreign members and foreign branches on that date. For this purpose, "liquid assets" includes only money, bank deposits (other than time deposits) and indebtedness which when acquired had a maturity of 2 years or less. The amount of increase in foreign assets remaining after reduction for these five items represents that maximum amount of foreign investment which may be considered attributable to producer's loans and thus give rise to a deemed distribution to the shareholders of the DISC.

The amount deemed distributed as a result of foreign investment is, however, subject to the further limitation that it is not to exceed the smaller of the actual amount of funds transferred abroad by domestic members of the group or the amount of the DISC's outstanding producer's loans to all members of the group. The amount of funds transferred abroad is the sum of the contributions to capital by domestic members of the group to foreign members of the group, increases in branch assets, the outstanding amount of stock and debt obligations (other than normal trade indebtedness) of foreign members of the group issued to domestic members of the group and one-half of the earnings of any foreign subsidiaries in the group and of branches of domestic members of the group.

However, since the potential abuse is the use of amounts borrowed from a DISC as a source of foreign investment, the total amount of outstanding producer's loans is the ultimate consideration in determining the amount of foreign investment attributable to producer's loans. Thus, if the total amount of the outstanding producer's loans (reduced to the extent the loans were taken into consideration in the past in determining the amount of foreign investment deemed distributed) is less than the actual amount invested in foreign assets, only the amount of the producer's loans will be deemed distributed. If, on the other hand, the outstanding producer's loans exceed the amount actually invested abroad by domestic members, then only the amount actually invested will be deemed distributed.

7. Special rules (sec. 501 of the Act and sec. 996 of the code)

A DISC corporation may have three different kinds of earnings and profits: the tax deferred income, called DISC income; income already taxed to the shareholders because of deemed distributions, called previously taxed income; and, earnings and profits taxable to both the corporation and the shareholders, called other earnings and profits, which were earned when the corporation was not in a DISC status. This section is largely concerned with determining in the case of any particular distribution which of these types of income is to be considered as being distributed and how the distribution is to be treated.

Most actual distributions are considered as made first out of previously taxed income (to the extent of income), then out of deferred DISC income (again, to the extent of this income), and, finally, out of other earnings and profits. Since the previously taxed income has already been taxed to the shareholders in deemed distributions, it is considered as distributed before the tax deferred DISC income. While this priority appears appropriate in the case of most actual distributions, it does not appear so in the case of distributions made to qualify for the 95 percent gross receipts or asset tests. To permit these qualifying distributions to be made out of previously taxed income would be inappropriate, since these are required because the receipts or assets involved are not export related. These distributions, therefore, are first considered as made out of the deferred DISC income and, only after other earnings and profits are distributed, as out of previously taxed income. Rules also are needed to determine which of these types of earnings and profits are absorbed by losses. These, of course, may, or may not, arise in a year in which a corporation is a DISC. When they arise in a non-DISC year, under the regular rules they reduce other earnings and profits. The Act, therefore, provides that losses are first to reduce other earnings and profits, then DISC income, and only finally income which has previously been taxed to the shareholders.

This section also contains a number of other rules necessary to the taxation of distributions to shareholders.

It provides, for example, for the order in which distributions are to be considered as made during the year. The first distributions made are deemed distributions. Next in order of priority are those made to provide qualification for the gross receipts and assets tests. This maximizes the likelihood of these being taxed to the shareholder. Last in order of priority are other actual distributions.

A second rule is necessary where ordinary income is taxed to a shareholder because of the sale of stock (or in the case of a taxable redemption of stock). As previously indicated, an ordinary income tax is imposed on the shareholder in such a case commensurate with the portion of his gain representing deferred DISC income at the corporate level. A rule is provided which, on an individual basis, in effect, to the extent of the ordinary income taxed to the shareholder, shifts DISC income to previously taxed income so the successor in interest of this stock will not be taxed on this income again when it is actually distributed by the corporation. In the case of the redemption of stock, essentially the same rule applies, except that because the payments are made by the corporation there is no need to transfer an amount to previously taxed income.

A third rule provides for the necessary change in basis for stock when a shareholder is taxed on a distribution which he does not receive and, subsequently, when he receives a distribution on which he is not taxed. In the first case, the basis for his stock goes up, since this is the equivalent of receiving the income and contributing it back to the corporation. In the second case, the basis of his stock goes down, since this is the equivalent of "a return of capital" from the corporation which is not taxed to the shareholder.

A fourth rule spells out the fact that earnings and profits consist of three divisions: DISC income; previously taxed income, which, as its name implies, represents the deemed distributions already taxed to the shareholder; and, then, other earnings and profits which arise in a year in which the corporation was treated as an ordinary corporation rather than a DISC.

Finally, a rule provides that where a nonresident alien or foreign corporation, estate or trust receives a distribution out of deferred DISC income from a DISC or has gain taxed as ordinary income on the sale of stock, it is to be taxed in the same manner as if the individual were a resident or domestic corporation—otherwise, the deferred income in such cases might escape tax entirely. This is accomplished by designating this income as "effectively connected" to the conduct of a trade or business within the United States.

Treatment of actual distribution.—The Act provides that actual distributions by a DISC (or former DISC) to shareholders out of earnings and profits are to be considered as made, to the extent thereof, first out of previously taxed income, then out of accumulated DISC income and finally out of other earnings and profits of the corporation.

The type of actual distribution referred to here does not include a distribution made in order to qualify as a DISC (sec. 992(c)).[11]

Accordingly, to the extent a DISC (or former DISC) has previously taxed income as a result of deemed distributions being taxed to shareholders, actual distribution are first considered as being made from this source (and, as subsequently indicated, to that extent are to be excluded from the shareholder's gross income[12] and are to re-

[11] Actual distributions for this purpose also do not include distributions to which section 995(c) applies (e.g., a distribution in redemption of stock).

[12] However, to the extent the previously taxed income would reduce the shareholder's basis below zero, capital gain is recognized.

duce the basis of his DISC stock). Of course, amounts distributed out of previously taxed income reduce the amount of previously taxed income of the corporation.

To the extent a distribution to a DISC's (or former DISC's) shareholders exceeds the previously taxed income, the distribution is to be treated as out of the accumulated DISC income (and as subsequently discussed, is not eligible for the dividends received deduction, but is generally treated as foreign source income).

The priority rules provided by the Act assure that, in the case of actual distributions, shareholders of a DISC (or former DISC) will be able to receive from the DISC amounts attributable to the deemed distributions, on which they previously have been taxed, prior to receiving taxable distributions. On the other hand, the rules insure that the shareholders must pay a tax on the DISC's tax-deferred income before they may receive dividends from the other earnings and profits of a corporation which are eligible for the dividends received deduction.

Distributions to meet qualification requirements.—As previously indicated, a corporation seeking to qualify as a DISC which has an excess amount of nonqualified gross receipts or nonqualified assets, is nevertheless permitted to qualify as a DISC if it makes a distribution of the nonqualified amounts. Since these distributions are viewed as consisting of nonqualified receipts or assets, it is thought they should be currently subject to taxation. As a result, it is necessary to provide a different priority rule for this type of distribution than that which applies in the case of other types of actual distributions to a DISC's shareholders.

To insure that these distributions are currently subject to taxation, they are treated as made, first out of accumulated DISC income, then out of other earnings and profits, and finally out of previously taxed income, to the extent of each of these amounts.

Treatment of losses.—The Act provides that if a DISC (or former DISC) incurs a deficit in earnings and profits, the deficit is to be charged first to the DISC's other earnings and profits, then to its accumulated DISC income, and finally to its previously taxed income, to the extent of each of these types of earnings. Since the DISC's other earnings and profits have already borne tax at the corporate level, the deficit is charged against those earnings and profits before it reduces the accumulated DISC income which has not yet been subject to tax.[13]

Because it is desired that each period of qualification as a DISC be treated separately, and that the deemed distribution resulting from a disqualification or termination not be diminished by a deficit in earnings and profits occurring subsequent to the period of previous

[13] For example, assume a corporation, which elected to be taxed as a DISC beginning in 1976, has the following earnings record:

1975—$50 of earnings and profits (prior to becoming a DISC)
1976—$10 of DISC income
$8 of previously taxed income
1977—$10 of DISC income
$8 of previously taxed income
1978—$10 of DISC income
$8 previously taxed income

In 1979, asume that the DISC incurs a deficit in earnings and profits of $70. This deficit is charged first against other earnings and profits (exhausting that account) and next against DISC income. Thus the DISC, as of the beginning of 1980, would have DISC income of $10 and previously taxed income of $24.

qualification, the Act provides that a deficit occurring subsequent to a period of qualification is not to be applied against the DISC income which it has been determined is to be deemed distributed to the shareholders as a result of a revocation of election or other termination.[14]

Treatment of deemed distributions.—Any deemed distribution to shareholders of a DISC (or former DISC) is to be included in the shareholders' gross income as a dividend and increase the corporation's previously taxed income. The treatment applies to deemed distributions during qualified years as well as deemed distributions occurring upon the termination or disqualification of a DISC.

The amount of a deemed distribution made to a DISC's shareholders, if it is a deemed distribution upon disqualification or termination, also reduces accumulated DISC income. However, there is no similar reduction in accumulated DISC income for amounts which are deemed distributions during qualified years since these were taxed currently and not initially included in accumulated DISC income.

For example, assume an existing corporation (with earnings and profits of $200) becomes a DISC effective for the year 1975. Assume in that year, and the two following years, the corporation has DISC income (as of the end of the year) and deemed distributions as follows:

	1975	1976	1977
DISC income	$50	$70	$80
Deemed distributions (resulting in previously taxed income)	10	15	20

Assume further that during 1977 the DISC makes a cash distribution to its shareholders in the amount of $280. (As discussed below, the Act provides that deemed distributions are considered to have been made prior to any actual distributions during the year.) Thus, for the year 1977, the shareholders will be deemed to have received a distribution of $20, which will be taxable as a dividend. Accordingly, as of the end of 1977, before taking the actual distribution into account, the DISC has previously taxed income of $45 resulting from the distributions deemed made by the corporation during the years in which it was a DISC. Since the actual distribution of $280 made during 1977 is considered to have been made first from previously taxed income, the shareholders will be entitled to exclude $45 of the distribution from income. The remaining portion of the distribution ($235) is considered to consist of $200 of DISC income, and finally of $35 of other earnings and profits.

Priority of distributions.—The Act provides that deemed distributions are considered to have been made prior to actual distributions made during the same taxable year. Insofar as actual distributions are concerned, distributions to qualify the corporation as a DISC are

[14] For example, if a corporation became disqualified as a DISC for 1979, at which time it had $30 of accumulated DISC income accumulated over the prior 3 years, the shareholders would be deemed to have received distributions equal to their pro rata share of the accumulated DISC income ratably over the following 3 years, or a total deemed distribution of $10 per year. If the corporation incurred a deficit in earnings and profits for 1979, the deficit would not affect the status of the three-$10 deemed distributions resulting from the disqualification. Instead, the deficit would be charged first to other earnings and profits of the corporation, if any, and then to the previously taxed income. Any amount of the deficit then remaining would be available to reduce earnings and profits arising in future years.

considered to have been made prior to any other actual distributions made during the same taxable year.[15]

Subsequent effect of previous disposition of DISC stock.—As discussed above, the Act provides that a shareholder who disposes of his stock in a DISC (or former DISC) must, in certain instances, treat his gain realized as ordinary income to the extent of the accumulated DISC income attributable to the shares disposed of. Thus, to the extent of the gain treated as ordinary income the shareholder is treated as if he had received an actual distribution of accumulated DISC income. Since this ordinary income treatment arises only with respect to one shareholder, however, no adjustment is made at the corporate level to the accumulated DISC income or previously taxed income of the DISC. Adjustments at the corporate level reflect events affecting all the shareholders on a pro rata basis, rather than just one shareholder.

To provide appropriate treatment in the situation where only one shareholder is taxed on a portion of the corporation's accumulated DISC income by reason of a disposition of his stock the Act provides a special rule. Under this rule a subsequent holder of the stock is to have a special adjustment which, in effect, permits him to treat the receipt of a subsequent actual distribution (or a deemed distribution occurring as a result of the disqualification or termination of the DISC) of accumulated DISC income as if the distribution were made out of previously taxed income (and thus nontaxable) to the extent gain on the previous dispositions of the stock was taxed as ordinary income.[16]

This special adjustment rule continues to apply even though the stock is again transferred to another person.[17] It does not, however,

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[15] To illustrate the application of these priority rules, assume an existing corporation (owned by a single shareholder), with accumulated earnings and profits of $10, elects to be treated as a DISC. At the end of its first year of operation as a DISC, it has DISC income of $4 and previously taxed income of $2. In its next year of operation, it earns DISC income of $4. In April of that year, the DISC makes a qualifying distribution of $6 for the preceding year. In June, the stock of the DISC is acquired by another corporation in a tax-free "B" reorganization, which results neither in the recognition of gain nor in ordinary income treatment for the disposing shareholder. In September, the DISC makes an actual distribution to its new shareholder, the acquiring corporation, in the amount of $8. During the year the DISC received $2 of taxable income which is deemed to be distributed on the last day of the year. Of the three distribtuions (the $6 qualifying distribution to the first shareholder, the $8 actual distribution to the new shareholder, and the $2 deemed distribution to the new shareholder), the $2 deemed distribution is considered to have been made first. The deemed distribution thus is ordinary income to the new shareholder and increases previously taxed income by the same amount. The $6 qualifying distribution is considered to have been made next, and is considered to be entirely out of accumulated DISC income (sec. 996(a)(2)). Thus, the prior shareholder of the DISC will have ordinary income in the amount of the distribution and will not be entitled to the dividends received deduction with respect to such amount. The $8 actual distribution is considered to have been made last in order and is considered first out of previously taxed income of which the DISC has $4, next out of accumulated DISC income of which the DISC has $2, and last out of other earnings and profits, of which the DISC has a sufficient amount to cover this portion of the actual distribution. Accordingly, the new shareholder would be considered, insofar as the actual distribution of $8 is concerned, as having received $4 tax-free from previously taxed income, $2 from DISC income (which would not be eligible for the dividends received deduction) and $2 from other earnings and profits (which would be eligible for the dividends received deduction).

[16] For example, assume that a shareholder in a DISC is required to treat $20 of his gain on the sale of his DISC stock as ordinary income. Although the accumulated DISC income and the previously taxed income of the corporation are not adjusted to reflect this ordinary income treatment, the purchaser is to treat up to $20 of a subsequent actual distribution (or a deemed distribution resulting from termination or disqualification) out of accumulated DISC income in the same manner as a tax-free distribution from previously taxed income. Thus, if the corporation made an actual distribution to the purchaser of $15 out of accumulated DISC income, he would not be taxed on this amount, even though the corporation itself had no previously taxed income.

[17] For example, if the purchaser, in the example in the preceding footnote, transferred his DISC stock by gift to his son after having received the $15 distribution from the DISC which was tax-free to him under the special adjustment rule, the son would become entitled to the special adjustment rule. The amount of the special adjustment, however, would only be the excess of the gain treated as ordinary income to the original seller upon the sale, $20, over the amount previously treated as if it were from previously taxed income ($15). Consequently, an actual distribution by the DISC to the son of an amount up to $5 would be treated as tax-free to him.

apply with respect to gain on an acquisition by a DISC or former DISC of its stock or, in the event of such an acquisition, to gain on a transaction prior to the acquisition.

Since a redemption by a DISC of its stock is economically equivalent to the acquisition of the DISC stock by the remaining DISC shareholders, the Act provides in this case for a reduction in the corporation's accumulated DISC income to the extent of the ordinary income realized (as a result of sec. 995(c)) by the redeemed shareholder upon the redemption. If the redeemed shareholder was entitled to the special adjustment rule, the corporation's accumulated DISC income also is to be reduced by the amount of the special adjustment, i.e., the amount of the DISC income which the redeemed shareholder could have received tax-free.[18]

Adjustments to basis.—When a shareholder of a DISC (or former DISC) is taxed on a deemed distribution of an amount which remains in the corporation, it is in essence as if there had been an actual distribution of the amount to the shareholder followed by a contribution by him of the amount to the corporation's capital. In the latter case, the basis of the shareholder's stock in the corporation would be increased by the amount of the capital contribution. To provide the same treatment in the case of deemed distributions, the Act provides that the basis of a shareholder's stock in the corporation is to be increased by the amount taxed to him as a deemed distribution.

On the other hand, the tax-free receipt by a shareholder of a DISC or former DISC of an actual distribution out of previously taxed income is the equivalent of a tax-free distribution of capital which under normal rules would result in a reduction of the basis of his stock. Accordingly, it is provided that the basis of the shareholder's stock in the DISC is to be reduced by the amount received by him tax free from previously taxed income (including amounts received tax free pursuant to the special adjustment rule). If a distribution of previously taxed income exceeds the basis of the shareholder's stock, it is to be treated by him as gain from the sale or exchange of property.

Definitions of divisions of earnings and profits; treatment of deemed distributions.—The Act provides that the earnings and profits of a DISC (or former DISC) are to be divisible into three separate categories.

The first division, DISC income, consists of those earnings and profits on which tax has been deferred because of the corporation's classification as a DISC in the year the income was earned. Thus, DISC income for a taxable year is the earnings and profits of a DISC during that year before reduction for any actual distributions made during the year but after reduction for amounts deemed distributed currently in qualified years such as interest on producer's loans.

These amounts are omitted from DISC income, since they are taxed currently to the shareholders of a DISC and, therefore, do not represent earnings of a DISC on which tax has been deferred. If a DISC, because of its ownership of stock in a controlled foreign corporation, must include any amounts in its gross income, as a result of the application of subpart F, these amounts also are to be included in the

[18] For example, assume a DISC with $100 of accumulated DISC income redeems the stock of a shareholder who treats $25 of his recognized gain as ordinary income. Assume also that the redeemed shareholder, because of the special adjustment tax, could have received $30 of DISC income from the DISC tax-free. In this case, the accumulated DISC income of the corporation is to be reduced to $45 ($100 minus $55) as a result of the redemption.

DISC income division of earnings and profits for the year included in the DISC's taxable income.

The second division of a DISC's earnings and profits is previously taxed income. The amounts in this division represent the total of the amounts previously taxed to shareholders as deemed distributions (under sec. 995(b)), including both distributions when the corporation was and was not qualified as a DISC. Thus, if a shareholder is deemed to have received a distribution as a result of the termination of a DISC election, or the failure of the corporation to qualify as a DISC, or if he received a deemed distribution related to a qualified year of a DISC, the amount of any such deemed distribution is to increase previously taxed income and, in the case of a deemed distribution resulting from termination or disqualification, reduce accumulated DISC income.

The third division of a DISC's earnings and profits, is referred to as "other earnings and profits." This has reference to those earnings and profits of a DISC which were accumulated while the corporation was not taxed as a DISC (i.e., in a year prior to the corporation's election, or subsequent to the election if it did not qualify for the year). These are the "normal" earnings and profits of a DISC which are the same as the earnings and profits of an ordinary corporation which never was a DISC. As a result, these earnings and profits when distributed are eligible for the dividends received deduction and are not treated as foreign source income.

Effectively connected income.—The Act treats all actual and deemed distributions which are out of DISC income and gains which are taxed as ordinary income, insofar as shareholders of a DISC who are nonresident aliens or a foreign corporation, trust, or estate are concerned, as effectively connected with the conduct of a trade or business conducted through a permanent establishment by the shareholder within the United States. The effect of this provision is to place distributions from a DISC (both deemed and actual) and gains on the disposition of DISC stock treated as ordinary income (pursuant to sec. 995(c)) in the category of income which is subject to U.S. tax, when received by nonresident aliens and a foreign corporation, trust or estate on a net income basis and at the regular rate of tax.

8. Special subchapter C rules (sec. 501 of the Act and sec. 997 of the code)

The amount distributed in the case of a distribution of property (as distinct from money) to a corporate distributee usually is measured by reference to the basis of the property distributed, rather than its fair market value as is the case with distributions to individuals. In addition, the basis of property received by a corporate distributee usually is the adjusted basis of property distributed in the hands of the distributing corporation. (See secs. 301(b)(1)(B), and 301(d)(2)). However, since the distribution of property from a DISC, out of DISC income or previously taxed income, is includible in the income of the recipient in full (or, in the case of previously taxed income, has previously been so included), without benefit of the dividends received deduction, it is more appropriate to treat the distributions under the same rules as apply to distributions to individuals. In this case, there is not the possibility of two taxes as there usually is where the dividends received deduction is not available and one corporation makes a distribution to another corporation.

Consequently, it is provided that the rules applicable to distributions to an individual are to apply to distributions by a DISC to the extent they are out of DISC income or previously taxed income (but not to the extent they are out of other earnings and profits where there is the possibility of a double tax.) Thus, the amount of these distributions in property are to be measured by the fair market value of the property distributed and the basis of the property distributed in the hands of the corporate distributee is to be its fair market value at the time of the distribution. To the extent that the distribution is out of the other earnings and profits of a DISC, the normal rules of section 301 are to apply.

The special rule described above, of course, has application to distributions by a former DISC to a corporate distributee, to the extent the distributions are out of the corporation's accumulated DISC income or previously taxed income.

9. Dividends received deduction (sec. 502 of the Act and sec. 246(d) of the code)

Generally, a corporation receiving a dividend from a domestic corporation is entitled to a deduction (usually equal to 85 percent of the dividend) in computing its taxable income. This intercorporate dividends received deduction is designed to prevent, for the most part, the multiple taxation of corporate earnings as they pass from one corporation to another. Since a DISC is not, however, subject to taxation on its earnings and profits as a DISC, there is no reason to provide for an intercorporate dividends received deduction for dividends distrbuted to corporate shareholders of a DISC.

As a result, the Act provides that the dividends received deduction is not to be available to corporate distributees to the extent dividends from a DISC (or former DISC) are out of accumulated DISC income, or previously taxed income, or are a deemed distribution in a year in which a corporation qualifies as a DISC (under sec. 995(b)(1)).

If, however, the dividend is made out of other earnings and profits, a corporate distributee is to be entitled to a dividends received deduction in the same manner and to the same extent as under the rules applicable to a distribution from a regular corporation.

10. Foreign tax credit (sec. 502 of the Act and secs. 901(d) and 904(f) of the code)

The Act makes the foreign tax credit available to shareholders of a DISC (or former DISC) for any foreign incomes taxes paid by the corporation with respect to certain distributions (whether deemed or actual). This is accomplished by providing that dividends from a DISC (or former DISC) are to be treated as dividends from a foreign corporation to the extent the dividends are treated as from sources without the United States. An amendment to the source rules (adding sec. 861(a)(2)(D) to the code) provides that dividends from a DISC are to be considered to be from sources without the United States to the extent attributable (as determined under regulations to be prescribed) to qualified export receipts (other than interest from U.S. sources) of the DISC.

By treating dividends from a DISC (or former DISC) as from a foreign corporation, to the extent the dividends are attributable to qualified export receipts (other than United States source interest), a corporate shareholder becomes entitled to the "deemed paid" foreign tax credit (sec. 902 of the code) with respect to any foreign income taxes paid by the DISC (or former DISC).

The Act also contains a provision which prevents a DISC shareholder, which has elected the overall limitation on the foreign tax credit, from using its excess foreign tax credits to offset its U.S. tax liability on the income received from a DISC (which is treated as foreign source income to the extent it is attributable to export receipts). As is the case with respect to interest income, it is provided that the tax credit limitation is to be applied separately with respect to DISC income. The Act further provides that the overall limitation will not apply with respect to dividends received from a DISC. Consequently, a DISC shareholder is not to be able to use excess foreign tax credits paid to a particular country (e.g., France) to offset its tax liability on the dividends received by it from a DISC. All dividends received from a DISC are considered to be received from one country. Thus, it is provided that if a taxpayer receives dividends from more than one DISC the aggregate of the dividends is to be considered in applying the per country limitation on the foreign tax credit.

11. Western Hemisphere Trade Corporations (sec. 502 of the Act and sec. 922 of the code)

The Act provides that a corporation which is a DISC for a taxable year and which also would otherwise qualify as a Western Hemisphere trade corporation for the year is not to be allowed the special Western Hemisphere trade corporation deduction (which is equivalent to a 14 percentage point rate reduction) for that year. Denial of the deduction will insure that during this period a DISC does not receive the double benefit of Western Hemisphere trade corporation treatment and DISC treatment. The special deduction is available to a former DISC if it otherwise qualifies for the deduction.

In addition, the Act also provides that a corporation may not receive the special Western Hemisphere trade corporation treatment for any year for which it owns stock in a DISC or former DISC. It would be inappropriate to accord tax-deferred status to a DISC's profits when earned by the DISC and, in addition, the special Western Hemisphere trade corporation tax rates on those profits when they are distributed by the DISC.

12. Possessions' corporations (sec. 502 of the Act and sec. 931(a) of the code)

Under present law, a U.S. corporation is treated as a possessions' corporation if most of its income is derived from a possession. A possessions' corporation is taxable by the United States only on its U.S. source income. If a possessions' corporation were allowed this special treatment for a taxable year in which it was a shareholder in a DISC or former DISC, the tax-deferred profits of the DISC or former DISC which were distributed or deemed distributed to the possessions' corporation would be free of tax in the possessions' corporation's hands, since they are not treated as U.S. source income. To prevent this result, it is provided that the special possessions' corporation treatment is not to be available to a corporation for any year in which it owns stock in a DISC or former DISC. The Act also provides that this treatment is not to be available when the corporation is, itself, a DISC.

13. Consolidated tax returns (sec. 502 of the Act and sec. 1504(b) of the code)

The Act provides that a DISC or former DISC may not be included in a group of affiliated corporations electing to file a consolidated tax return. An affiliated group of corporations which files a consolidated tax return, in effect, is allowed a 100 percent dividends received deduction on dividends flowing from one member of the group to another. The allowance of this treatment, like the allowance of the general dividends received deduction, is not compatible with the principle that earnings of a DISC are not to be taxed in the hands of the DISC but rather are to be taxed in the hands of its shareholders.

14. Special rule with respect to DISC stock acquired from a decedent (sec. 502 of the Act and sec. 1014(d) of the code)

In order to prevent the possibility of a DISC shareholder, who receives stock of a DISC (or former DISC) from a decedent, from escaping taxation on the DISC income attributable to those shares when they are disposed of by him, the Act provides a special basis rule with respect to such stock when acquired from a decedent.

An amendment to the general basis rule relating to property acquired from a decedent (sec. 1014) provides that the basis given stock of a DISC (or former DISC) acquired from a decedent is to be the basis of the property determined under the general rule in such cases (fair market value upon the applicable estate tax valuation date) but reduced by the amount which would have been treated as ordinary income (under sec. 995(c)) had the decedent lived and sold the DISC stock at its fair market value on the applicable estate tax valuation date. Thus, the basis of DISC stock in the hands of an individual acquiring such stock from a decedent is still to reflect the potential taxation to such individual (as ordinary income) of the DISC income attributable to the acquired shares.

This rule can be illustrated by assuming that A, possessing DISC stock with a basis of $60 in his hands, dies when the stock has a fair market value of $100. Assume further that A's fiduciary elects the date of death valuation for Federal estate tax purposes. If the amount which would have been ordinary income if the shares were sold on the date of death is $30, the basis of such stock to the legatee (B) would be $70 (the fair market value at death, $100, reduced by $30). Consequently, the subsequent sale of the inherited DISC stock by B for $100 would (assuming no decrease in the DISC income attributable to such shares) generate $30 of ordinary income to B.

The rule provided by the Act has application whenever stock of a DISC (or former DISC) is included in the decedent's gross estate for Federal estate tax purposes. For example, if the DISC stock in the above example had been transferred by A to B in contemplation of death, the property would have been included in the decedent's gross estate and the basis in B's hands would be determined under the DISC rules in the same manner as if the stock had been acquired by B as a result of A's death.

Where the decedent's fiduciary elects the alternate evaluation date for Federal estate tax purposes (pursuant to sec. 2032), in computing the gain which the decedent would have had if he had sold the DISC stock on the alternate valuation date, his basis is to be determined with reduction for any distributions which may have been made, after the date of the decedent's death and before the alternate valuation date, from the DISC's previously taxed income. By providing that the decedent's basis in the hypothetical sale is reduced by post-death distributions from previously taxed income, it is insured that the basis of the beneficiary will reflect the fact that a distribution has been made from previously taxed income during administration and prior to the alternate valuation date. For example, assume that A dies possessing DISC stock with a basis of $100, which stock is bequeathed to B. If the stock has a value of $110 on the alternate valuation date, its basis to B (assuming that the corporation has $50 of DISC income and $10 of previously taxed income) would be $100 ($110 less $10, the amount which would have been treated as ordinary income if the decedent had lived and sold the stock on the alternate valuation date). On the other hand, if a distribution of $10 had been made from previously taxed income prior to the alternate valuation date, B's basis would be $90 ($100, the fair market value of the stock on the alternate evaluation date (as adjusted above), less $10, the amount which would have been treated as ordinary income if the decedent had lived and sold the stock on the alternative valuation date).

15. Procedure and administration (sec. 504 of the Act and secs. 6011, 6072, 6501, and 6686 of the code)

The Act provides various reporting and recordkeeping procedures for the corporations which are or were DISC's. A DISC is to file a tax return for its taxable year on or before the 15th day of the 9th month following the close of the taxable year on such forms as are prescribed by the Treasury. A DISC or former DISC also must furnish for a taxable year such information to the Internal Revenue Service, and to any persons who were shareholders of the corporation at any time during the taxable year, as the Treasury requires by regulations. In addition, a DISC or former DISC must keep such records as are required by Treasury regulations.

Generally, the statute of limitations on the assessment of tax by the Internal Revenue Service against a corporation begins to run on the due date for the corporation's tax return (if the return is filed by that time). For purposes of applying this rule it is provided that if a corporation in good faith determines it is a DISC and files a DISC tax return for a taxable year, that tax return is to be considered as a regular corporate tax return. Thus, if the corporation subsequently is held not to be a DISC for the year, the filing of the DISC tax return will have started the statute of limitations running for purposes of assessments of tax against the corporation.

Penalties (which are in addition to the penalties provided in section 7203 regarding willful failures to file returns, supply information, or pay taxes) are provided for a failure to file a DISC tax return or to supply the information required under the Act. In the case of a failure to supply information, the penalty is to be $100 for each failure but the total penalty imposed for a calendar year with respect to failure to supply information may not exceed $25,000. In the case of a failure to file a DISC tax return, a penalty of $1,000 is imposed. These penalties, however, are not to apply in any case where the failure to supply information or file a DISC tax return is due to reasonable cause.

16. Export trade corporations (sec. 505 of the Act)

A U.S. parent corporation of a controlled foreign subsidiary is subject to tax currently on the foreign subsidiary's subpart F income (generally its trading, etc., income). If the foreign subsidiary, however, derives its trading income from the sale of U.S. exports and invests that income in export trade assets, then the tax liability of the parent company on a subsidiary's income is deferred as long as it remains invested in the export trade assets. To a large extent, the export trade corporation provisions of present law serve the same objective which the DISC treatment is designed to serve. Since there is a substantial overlap between these two sets of provisions, it is provided that corporations will not be eligible to use the export trade corporation provisions in the future. The Act provides that a corporation which was not an export trade corporation for a taxable year beginning before November 1, 1971, would not be eligible for treatment as an export trade corporation for taxable years beginning on or after that date.

This will allow those corporations which previously qualified under these provisions to continue to qualify under them. It is also provided that a corporation which fails to qualify as an export trade corporation for any period of 3 consecutive years beginning after October 31, 1971, may not again be eligible for treatment as an export trade corporation.

In addition, the Act also allows a parent corporation to transfer assets from its export trade corporation subsidiary to a DISC subsidiary without immediate tax consequences. If an export trade corporation desires to take advantage of the DISC provisions, the Act provides that if a parent corporation owns all the outstanding stock of an export trade corporation and all the outstanding stock of a DISC, then no gain or loss or immediate income tax consequences are to result to any of the corporations involved, if the export trade corporation contributes property to the DISC in situations where two conditions are satisfied. First, the amount transferred to the DISC must be at least equal to the amount of the export trade corporation's untaxed subpart F income (i.e., the previously earned subpart F income on which tax has been deferred by virtue of export trade corporation treatment). Second, the transfer must occur during a taxable year beginning before January 1, 1976. The Act provides that a foreign corporation which qualified as an export trade corporation for any three taxable years beginning before November 1, 1971, will be treated as an export trade corporation for purposes of the provision which allows a foreign corporation to transfer its assets to a DISC without tax consequences.

If the above described conditions are satisfied with respect to a transfer of property from an export trade corporation to a DISC, the Act provides that a series of adjustments are to be made with respect to the export trade corporation and the DISC to reflect the fact that the export trade corporation's tax deferred earnings have been transferred to the DISC. First, the earnings and profits of the DISC and its accumulated DISC income (i.e., its tax deferred income) are to be increased by the amount of any earnings and profits transferred to it (and the export trade corporation's earnings and profits are to be reduced by the same amount). This is to occur even if the amount transferred to the DISC is in excess of the export trade corporation's untaxed subpart F income, since the excess represents other untaxed foreign earnings. These amounts are to be treated as foreign source income when distributed by the DISC and the taxes paid by the export trade corporation on its earnings which are transferred to the DISC, in effect, are to be considered as paid by the DISC for purposes of determining the allowable deemed paid foreign tax credit which a corporate shareholder of the DISC is entitled to when it receives a dividend from the DISC.

Adjustments to the basis of the parent company's stock in the export trade corporation and the DISC also are provided by the Act so as to take account of the fact that all, or a portion, of the parent company's investment in its export trade corporation subsidiary has been transferred to its DISC subsidiary. It is provided that the basis of the parent's stock in the export trade corporation is to be reduced proportionately by the percentage of the export trade corporation's assets (measured by their adjusted basis) transferred to the DISC. For example, if 25 percent of an export trade corporation's assets were transferred to a DISC and the parent company's basis for its stock in the export trade corporation was $1 million, then that basis is to be reduced to $750,000. The amount by which the basis of the parent company's stock in its export trade corporation subsidiary is reduced is to be added to the basis of its stock in its DISC subsidiary.

In determining the amount of property transferred from an export trade corporation subsidiary to a DISC subsidiary, it is provided that the amount transferred is to be the adjusted basis of the transferred property with proper adjustment being made for any indebtedness secured by the property or assumed by the DISC in connection with the transfer.

The rules discussed above apply in the situation where the parent company directly owns all of the stock of both its export trade corporation subsidiary and its DISC subsidiary. In situations where either the 100 percent ownership requirement is not met or the direct ownership requirement is not met, it is provided that the rules discussed above are to be applicable to the extent and in accordance with such rules, as the Secretary of the Treasury provides. An example of the type of situation covered by this provision, for which rules are to be prescribed by the Treasury, would be where the export trade corporation is a second-tier foreign subsidiary which is to be spun off to the U.S. parent company and then merged into the DISC.

The Act also contains a provision which is designed to insure that accounts receivable, to the extent such receivables were export trade assets when held by the transferring export trade corporation, will be treated as qualified export assets in the hands of the DISC.

17. Submission of annual reports to Congress (sec. 506 of the Act)

In order that the Congress may be apprised of the effects of the DISC treatment provided by the Act, the Secretary of the Treasury is to submit an annual report to Congress setting forth an analysis of the operation and effect of the DISC system of taxation. Among other things, the report is to include an analysis of the revenue effects of the

DISC system as well as its effects on the balance of trade of the United States.

These reports, which are to begin with the report for calendar year 1972 are to be submitted to the Congress within 15½ months following the close of each calendar year.

In addition, before February 1, 1973, and every three years thereafter, the President was requested to submit to the Congress a comprehensive analysis of the manner in which the various countries of the world treat, for tax and tariff purposes, the export of manufactured and processed products.

G. Job Development Related to Work Incentive Program

(Sec. 601 of the Act and new sections 40, 50A, and 50B of the code)

The aim of the Revenue Act of 1971 was to expand job opportunities for all Americans. The job development investment credit under title I of the Act is the major instrument for accomplishing this goal. The Act also contains important provisions designed to expand job opportunities for welfare recipients participating in the Work Incentive Program.

The Work Incentive Program was created by the Congress in 1967 as an attempt to cope with the problem of rapidly growing dependency on welfare by providing recipients with the training and job opportunities needed to help them become economically independent. Unfortunately, the results have been disappointing, and few participants in the Work Incentive Program have been placed in employment following completion of participation in the program.

The major single criticism of the Work Incentive Program is that it has not placed welfare recipients in jobs. The reason for this is that well over ninety percent of the enrollees in the program are taking classroom-type courses rather than employment-based training. Two basic kinds of employment-based training are authorized under present law; on-the-job training with private employers and public service employment in created public jobs. These must be given a much higher priority if welfare recipients are to be employed rather than put into training programs leading nowhere.

Employment in the private sector represents our major hope for leading present welfare recipients to economic independence. As an incentive for employers in the private sector to hire individuals placed in on-the-job training or employment through the Work Incentive Program, the Act provides a tax credit equal to 20 percent of the wages and salaries paid to these employees during their first 12 months of employment.

The tax incentive is a key provision of the Act. Congress recognized that no work incentive or job training program can ever be successful unless it has the full cooperation of private business. Many welfare recipients will be very poor employment risks, unless they receive special training so that they can achieve full productivity. It is unrealistic to expect that the business community will undertake this kind of new responsibility without some form of extra financial help in the initial stages. The job development tax incentive is designed to bridge the gap that now exists between the Work Incentive Program and private employment. Congress believed that use of the job development tax credit by employers can only result in savings to taxpayers. There has been virtually no on-the-job training or placement of welfare recipients in private employment under the present program. Any use of the tax credit, therefore, will amount to employment that would in all likelihood not otherwise have taken place. Let us assume that a former welfare recipient is placed in a job paying $5,000 per year. The tax credit amounts to $1,000 *if the former recipient works for two full years*. Welfare payments during those two years in most States would have amounted to more than five times that amount.

Under this job development tax credit, as indicated above, a taxpayer is to be allowed as a credit against his income tax liability for the taxable year an amount equal to 20 percent of "Work Incentive Program expenses" which he has paid or incurred during the year. However, the credit for a taxable year may not exceed $25,000 plus 50 percent of the taxpayer's income tax liability in excess of $25,000. "Work Incentive Program expenses" are defined as the wages and salaries attributable to the first 12 months of employment of employees who are placed in employment under the Work Incentive Program established by the Congress in 1967. The wages paid an employee placed in on-the-job training after participation in the Work Incentive Program would similarly be considered a "Work Incentive Program expense." The Act makes clear that the credit is not to be available with respect to wages or salaries paid to domestic employees. On the contrary, it is provided that only wages and salaries paid in the course of a trade or business are to qualify.

If the taxpayer without cause terminates the employment of an employee placed under the Work Incentive Program at any time during the first 12 months of employment or at any time during the next 12 months, then the tax credit allowed under this provision with respect to that employee is to be recaptured. In such a case, the tax liability of the taxpayer, for the year of termination, would be increased by an amount equal to previous tax credits allowed for Work Incentive Program expenses incurred with respect to the discharged employee. The recapture provision is not to apply if the termination of employment is voluntary by the employee, or if it is due to disability, or if it is determined under the State unemployment compensation law that the termination was due to misconduct by the employee.

This provision also permits any unused tax credits under this section to be carried back three taxable years and then to be carried forward seven taxable years. The unused credit carryback may be used to reduce any income tax liability for the years to which it is carried. However, any unused credit for a year may only be carried back to taxable years beginning after December 31, 1971.

The provision contains several limitations. A credit may not be taken for Work Incentive Program expenses which do not qualify as deductible trade or business expenses, or if the expenses have been reimbursed to the taxpayer. Further, the credit is not allowed for any expenses of training conducted outside the United States. Also, no work incentive program expenses on behalf of an employee may be used in computing the credit if the expenses are incurred after the end of the 24-month period beginning with the date of initial employment by the taxpayer. In addition, no Work Incentive Program expenses may be taken into account with respect to an employee who is closely related to the taxpayer. If the taxpayer is a corporation, estate or trust, special rules are provided to achieve a similar result. The credit is to be allowed with respect to any Work Incentive Program participant only if the Secretary of Labor certifies that his employment did not displace another individual from employment. Additionally, the credit is to be allowed only for wages paid in cash. Finally, the Act requires that the wages paid to a Work Incentive Program participant must be equal to wages paid non-participating employees of the employer performing comparable service.

The provision is effective for taxable years beginning after December 31, 1971.

H. Tax Incentives for Contributions to Candidates for Public Office

(Secs. 701–703 of the Act and secs. 41 and 218 of the code)

Under prior law, there was no provision to permit either a tax credit or a deduction for contributions made to candidates for public office or to political organizations for use in the campaign for nomination or election to a public office. In order to encourage more widespread financing of political campaigns through small contributions, Congress added two sections to the Code to allow an individual taxpayer the option to elect to use either a credit against his income tax liability or an itemized deduction from adjusted gross income for a limited amount of political contributions. These provisions, by encouraging small scale private contributions and thereby broadening the base of political financing, help to reduce the dependency of candidates on large contributors and special interest groups.

The credit (sec. 41) provided by the Revenue Act of 1971 is allowed against an individual's income tax liability for one-half of the political contributions made during the year, with a maximum credit of $25 in the case of a joint return of husband and wife (and $12.50 in the case of a separate return of a married person or a single person). The credit, however, is not to exceed the amount of personal tax liability for the taxable year reduced by the sum of any foreign tax credit (sec. 33), any credit for partially tax-exempt interest (sec. 35), any retirement income credit (sec. 37), and any investment credit (sec. 38).

In place of the credit, an individual taxpayer may take a deduction (sec. 218) from adjusted gross income for the amount of political

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contributions made during the taxable year. The maximum deduction allowed in the case of a joint return is $100 ($50 in the case of the return of a single person or a married person filing a separate return). An estate or trust is not allowed either the credit or the deduction. A political contribution is defined by the Act as a contribution or gift of money to a candidate or campaign committee for use in furthering the candidacy of an individual for public office, or to a national, State or local committee of a national political party.

A candidate is defined by the Act as an individual who has publicly announced that he is a candidate (and meets the qualifications prescribed by law for the office) for nomination or election to a Federal, State, or local elective public office in a primary, general, or special election. A qualified campaign committee must be operated exclusively for the purpose of influencing (or attempting to influence) the nomination or election of one or more individuals who are candidates for nomination or election to any Federal, State, or local elective public office. The term national political party means a political party presenting candidates or electors for the offices of President and Vice President on the official election ballot of ten or more States (for contributions made during a taxable year in which the electors are chosen), or in the case of contributions made during any other taxable year, a political party which met these qualifications in the last preceding election of a President and Vice President of the United States.

The credit or deduction is to be allowed only if the political contributions are verified in such manner as are prescribed by regulations. The allowance of the credit or deduction apply to payments of political contributions made after December 31, 1971, and for taxable years ending after that date.

The decrease in tax liability from the allowance of the credit or deduction is estimated to be $100 million for calendar year 1972 and $25 million for calendar year 1973.

I. Financing of Presidential Election Campaigns

(Secs. 801 and 802 of the Act and secs. 6096, 9001–9013, and 9021 of the code)

In 1966, Congress enacted the Presidential Election Campaign Fund Act (in P.L. 89–809) for financing presidential political campaigns. This Act provided for each taxpayer to designate or check off on his Federal income tax return if he wanted $1 of his tax set aside for a political contribution. The total amount raised in this manner was to be divided equally between the two major political parties. In 1967, however, Congress amended this provision by suspending its operation until adoption of legislative guidelines. These legislative guidelines were not enacted prior to the Revenue Act of 1971.

There has been much concern with the possible ramifications of the manner in which national political campaigns are presently financed and soaring campaign costs have recently intensified this concern.[1] Dependence on wealthy contributors for the bulk of needed funds tends to leave candidates of modest means encumbered with stronger debts of loyalty to the wealthy few than to the voting public. It is felt that an alternative source of financing political campaigns must be developed to remove the cause of much of the improper influence in Government. Political parties and their presidential candidates should be assured that they need not rely on the large contributions of relatively few wealthy contributors to meet the heavy financial demands of political campaigns. Instead, a system of campaign financing should be adopted in which the President will be obligated equally to every taxpayer and to every voter.

The Act provides a system of public financing as an alternative way of financing the general election campaigns of presidential and vice-presidential candidates. The candidates of each major party will be entitled to public financing in an amount equal to 15 cents multiplied by the number of residents in the United States who are age 18 years old or older as of the first day of June of the year preceding the presidential election. (A major party for this purpose is a party which in the preceding presidential election received 25 percent or more of the total number of popular votes received by all candidates for President in that election.) A minor party would be eligible to receive that percentage of the entitlement of a major party which the minor party vote in the preceding presidential election is of the average vote received by the two major parties in that election. (A minor party for this purpose is one that received more than 5 percent but less than 25 percent of the popular vote in the preceding presidential election.)

The Act also provides that a new party may share in public financing after the election if it obtains more than 5 percent of the popular vote in the election. The new party will receive that percentage of the entitlement of a major party which the new party's vote in the current election is of the average number of popular votes received in that election by the major parties. Under this same provision, a minor party can increase its basic entitlement if its proportion of votes in the current election exceeds its proportion of votes in the preceding presidential election.

Public financing is provided by a so-called check-off system, starting with income tax returns for the calendar year 1972. Under this system, an individual can designate that $1 of his tax liability be set aside in a special account in the Presidential Election Campaign Fund for the candidates of a political party specified by the taxpayer. Alterna-

[1] The reasons presented here are adapted from the reasons given in the Senate Finance Committee report on the legislation passed in 1966 (Report No. 1707, H.R. 13103). Because this provision was added during the Senate debate in 1971 there were no reasons included in the report at that time for this legislation.

tively, the taxpayer can direct that the $1 will be set aside in a non-partisan general account in the fund. In the case of a joint return having a tax liability of $2 or more, each spouse may designate that $1 is to be paid into an account.

The size of the fund will thus be determined by the voluntary acts of individual taxpayers, each of whom will have the opportunity to make a financial contribution of similar size. If no designation is made, nothing will be set aside in any account as a result of the filing of the tax return. The payments into the fund will be made only as provided by appropriation acts, in amounts not in excess of the amounts checked off on tax returns.

If the candidates of a political party elect public financing, payments to the candidates may be made only out of the special account designated for that party. The Act provides for transfer of moneys in the fund from the non-partisan general account to the separate accounts of the political parties on the 60th day before the election, based upon the entitlement at that time of the major parties and the minor parties. At that time, however, not more than 80 percent of the moneys in the general account may be allocated to the special accounts of the parties.

Moreover, no amount, may be transferred to a special account which would bring the funds in that account above the entitlement of the candidates to which the account relates. If the funds in any separate account are insufficient at the end of the expenditure report period (30 days after the election) to satisfy any unpaid entitlement of the eligible candidates to which the account relates, the balance in the general account (i.e., the 20 percent plus any other amounts not distributed 60 days before the election are to be transferred to the separate accounts in accordance with the popular votes received by the parties in the current election.

If a major party elects public financing, it cannot spend on the general campaign more than its entitlement (15 cents times the number of the residents of the United States who are 18 years old or older in the preceding year): and it cannot accept contributions for the general campaign if there is sufficient money in its special account to pay its full entitlement. If there is a deficiency in the account, contributions can be accepted but only to the extent of this deficiency.

A minor party or a new party can accept contributions from private sources, but it must agree that it will not spend more in the general campaign than the amount of the entitlement of a major party, and that it will return campaign contributions to the extent they exceed the campaign expenses not covered by public financing.

Public financing provides funds for expenditures related to the campaign period (and establishes limits on total expenditures for this period) beginning with the date on which the first major party nominates its candidate for President and ending on the date 30 days after the election. The Comptroller General is to certify the amount payable out of the accounts to the eligible candidates (candidates who elect public financing).

Candidates for President and Vice President (whether or not they have elected public financing) are required to furnish the Comptroller General, from time to time during the general campaign, with a statement of the amount spent—and proposed to be spent—on the campaign. The Comptroller General is required to publish in the Federal Register a summary of these expenses. These expenditure reports include the amounts spent by committees authorized or recognized by candidates whether or not eligible candidates.

The eligible candidates are to file with the Comptroller General a list of committees who are authorized to spend money on their behalf. It is unlawful for any committee which is not an authorized committee, to spend more than $1,000 during the general campaign on behalf of the candidacy of the eligible candidates of a party. The prohibition against expenditures in excess of $1,000 by organizations which are not authorized committees does not apply to broadcasting organizations or newspapers (or other periodicals) in reporting the news or editorial opinions, or to tax-exempt organizations reporting to their members the views of the organization with respect to presidential candidates.

Criminal penalties are provided for willful violations constituting prohibited transactions.

The Act also adds a provision to allow the Comptroller General or other interested parties to bring court actions in order to implement or construe the new provisions. For this purpose the Comptroller General is authorized to employ his own legal counsel. Because these provisions will have a direct and immediate effect on the actions of individuals, organizations, and political parties with respect to the financing of campaigns for the offices of President and Vice President of the United States, these individuals, organizations, and political parties must know whether major and minor parties may expect to receive financing under the provisions of this title or whether political parties and others should continue to solicit, and individuals, organizations, and others should continue to make, contributions to provide this financing. Accordingly, the Act provides for expeditious disposition of legal proceedings brought with respect to these provisions. The agreement provides for actions involving these provisions to be brought before a three-judge district court, to be expeditiously tried, and for appeals from decisions of that court to go directly to the Supreme Court.

A Presidential Election Campaign Fund Advisory Board is created to assist the Comptroller General in performing his duties. The Board is to be composed of the Majority Leader and the Minority Leader of the Senate and the Speaker and Minority Leader of the House of Representatives (who will serve ex officio), two members representing each political party which is a major party, and three members representing the general public. The members of the Board representing the major political parties and the general public will serve 4-year terms ending 60 days after the date of each presidential election. Both members will be compensated at the rate of $75 a day for each day they serve and will receive travel expenses and a per diem in lieu of subsistence (at rates authorized for persons in intermittent Government service) when engaged in work away from their home or regular places of business.

The Act provides that the provision takes effect on January 1, 1973, so that the first election to which it will apply will be the 1976 presidential election. This means that the check-off system commences with income tax returns filed for the calendar year 1972.

V. STATISTICAL APPENDIX

TABLE 1.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), ELIMINATING THE PHASEOUT FROM THE 1971 MINIMUM STANDARD DEDUCTION[1] AND INCREASING THE 1971 EXEMPTION FROM $650 TO $675, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5, 555	170	20	$56
$3 to $5	9, 460	95	230	227
$5 to $7	9, 154	58	701	310
$7 to $10	13, 316	2	317	223
$10 to $15	15, 084			276
$15 to $20	6, 334			135
$20 to $50	4, 014			116
$50 to $100	398			20
$100 and over	99			5
Total	63, 415	325	1, 268	1. 368

[1] Under prior law the minimum standard deduction for 1971 was $1,050 "phased out" by reducing the additional allowance (difference between the 1969 minimum standard deduction and $1,050) by $1 for every $15 of adjusted gross income in excess of the 1971 nontaxable level; the Revenue Act of 1971 eliminated the phaseout thus making the minimum standard deduction a flat $1,050.

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

TABLE 2—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), ELIMINATING THE PHASEOUT FROM THE 1971 MINIMUM STANDARD DEDUCTION,[1] 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of of returns made nontaxable [2] (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5, 407		20	$33
$3 to $5	7, 622		230	160
$5 to $7	6, 166		701	217
$7 to $10	2, 814		317	33
$10 to $15				
$15 to $20				
$20 to $50				
$50 to $100				
$100 and over				
Total	22, 008		1, 268	443

[1] Under prior law the minimum standard deduction for 1971 was $1,050 "phased out" by reducing the additional allowance (difference between the 1969 minimum standard deduction and $1,050) by $1 for ever $15 of adjusted gross income in excess of the 1971 nontaxable level.

[2] A small but indeterminate number of returns are rendered nontaxable by this provision.

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

TABLE 3.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), INCREASING THE 1971 EXEMPTION FROM $650 TO $675, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,555	170		$23
$3 to $5	9,460	95		67
$5 to $7	9,154	58		94
$7 to $10	13,316	2		190
$10 to $15	15,084			275
$15 to $20	6,334			135
$20 to $50	4,014			116
$50 to $100	398			20
$100 and over	99			5
Total	63,415	325		925

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

TABLE 4.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), ADVANCING 1973'S 15 PERCENT STANDARD DEDUCTION AND $750 EXEMPTION TO 1972[1] AND INCREASING THE MINIMUM STANDARD DEDUCTION FROM $1,000 TO $1,300, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,531	1,774	141	$225
$3 to $5	9,273	691	577	437
$5 to $7	9,069	269	1,000	526
$7 to $10	13,316	44	916	608
$10 to $15	15,084		657	689
$15 to $20	6,334			267
$20 to $50	4,014			231
$50 to $100	398			39
$100 and over	99			11
Total	63,117	2,777	3,291	3,083

[1] Thus changing 1972's $700 exemption to $750 and 1972's 14 percent standard deduction (with $2,000 ceiling) to 15 percent (with $2,000 ceiling).

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

TABLE 5.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), ADVANCING 1973'S 15 PERCENT STANDARD DEDUCTION AND $750 EXEMPTION TO 1972,[1] 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,531	274		$45
$3 to $5	9,273	325		129
$5 to $7	9,069	201		187
$7 to $10	13,316	44	470	493
$10 to $15	15,084		657	689
$15 to $20	6,334			267
$20 to $50	4,014			231
$50 to $100	398			39
$100 and over	99			11
Total	63,117	844	1,127	2,091

[1] Thus changing 1972's $700 exemption to $750 and 1972's 14 percent standard deduction (with $2,000 ceiling) to 15 percent (with $2,000 ceiling).

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

TABLE 6.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), ADVANCING 1973'S 15 PERCENT STANDARD DEDUCTION TO 1972 [1], 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3				
$3 to $5	446			$3
$5 to $7	1,239			8
$7 to $10	7,657		470	123
$10 to $15	6,808		657	146
$15 to $20				
$20 to $50				
$50 to $100				
$100 and over				
Total	16,151		1,127	279

[1] Thus changing 1972's 14 percent standard deduction (with $2,000 ceiling) to 15 percent (with $2,000 ceiling).

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

TABLE 7.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), ADVANCING 1973'S $750 EXEMPTION TO 1972 [1], 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,531	274		$44
$3 to $5	9,273	325		126
$5 to $7	9,069	201		179
$7 to $10	13,316	44		370
$10 to $15	15,084			543
$15 to $20	6,334			267
$20 to $50	4,014			231
$50 to $100	398			39
$100 and over	99			11
Total	63,117	844		1,811

[1] Thus changing the exemption in 1972 from $700 to $750.

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

TABLE 8.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), INCREASING THE MINIMUM STANDARD DEDUCTION TO $1,300, FOR CALENDAR 1972 AND THEREAFTER,[1] 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,174	1,500	141	$180
$3 to $5	7,770	366	577	358
$5 to $7	6,878	68	1,000	339
$7 to $10	5,132		446	115
$10 to $15				
$15 to $20				
$20 to $50				
$50 to $100				
$100 and over				
Total	24,954	1,933	2,164	992

[1] Thus increasing the minimum standard deduction in 1972 and thereafter from $1,000 to $1,300.

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

TABLE 9.—FEDERAL INDIVIDUAL INCOME TAX BURDEN [1] UNDER PRIOR LAW AND UNDER THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), TAX LIABILITY, CALENDAR YEARS 1971, 1972, AND 1973 AND THEREAFTER

[Assuming deductible personal expenses of 10 percent of income]

Adjusted gross income (wages and salaries)	1971				1972				1973 and thereafter			
		Revenue Act of 1971 [2]				Revenue Act of 1971 [3]				Revenue Act of 1971 [4]		
			Tax decrease				Tax decrease				Tax decrease	
	Prior law tax	Tax	Amount	Percent	Prior law tax	Tax	Amount	Percent	Prior law tax	Tax	Amount	Percent
Single person:												
$1,700 [5]	0	0	0		0	0	0		0	0	0	
$1,725 [6]	$4	0	$4	100.0	$4	0	$4	100.0	0	0	0	
$1,750 [7]	7	$4	3	42.9	7	0	7	100.0	0	0	0	
$2,050 [8]	52	46	6	11.5	49	0	49	100.0	$42	0	$42	100.0
$3,000	207	189	18	8.7	193	$138	55	28.5	185	$138	47	25.4
$3,500	296	272	24	8.1	276	217	59	21.4	268	217	51	19.0
$4,000	396	362	34	8.6	367	302	65	17.7	358	302	56	15.6
$5,000	599	552	47	7.8	557	491	66	11.8	548	491	57	10.4
$7,500	1,084	1,063	21	1.9	1,058	995	63	6.0	1,031	995	36	3.5
$10,000	1,603	1,596	7	.4	1,566	1,530	36	2.3	1,530	1,530	0	
$12,500	2,185	2,178	7	.3	2,104	2,059	45	2.1	2,059	2,059	0	
$15,000	2,877	2,869	8	.3	2,717	2,703	14	.5	2,703	2,703	0	
$17,500	3,551	3,543	8	.2	3,458	3,443	15	.4	3,443	3,443	0	
$20,000	4,289	4,281	8	.2	4,272	4,255	17	.4	4,255	4,255	0	
$25,000	5,933	5,924	9	.2	5,914	5,895	19	.3	5,895	5,895	0	

Married couple with no dependents:												
$2,350 [9]	0	0	0		0	0	0		0	0	0	
$2,400 [6] [10]	7	0	7	100.0	0	0	0		0	0	0	
$2,500 [7]	22	14	8	36.4	14	0	14	100.0	0	0	0	
$2,800 [8]	67	56	11	16.4	56	0	56	100.0	42	0	42	100.0
$3,000	97	84	13	13.4	84	28	56	66.7	70	28	42	60.0
$3,500	174	155	19	10.9	155	98	57	36.8	140	98	42	30.0
$4,000	254	230	24	9.4	230	170	60	26.1	215	170	45	20.9
$5,000	422	386	36	8.5	386	322	64	16.6	370	322	48	13.0
$7,500	853	829	24	2.8	820	753	67	8.2	786	753	33	4.2
$10,000	1,266	1,257	9	.7	1,228	1,190	38	3.1	1,190	1,190	0	
$12,500	1,754	1,743	11	.6	1,677	1,628	49	2.9	1,628	1,628	0	
$15,000	2,310	2,298	12	.5	2,172	2,150	22	1.0	2,150	2,150	0	
$17,500	2,873	2,860	13	.5	2,785	2,760	25	.9	2,760	2,760	0	
$20,000	3,456	3,442	14	.4	3,428	3,400	28	.8	3,400	3,400	0	
$25,000	4,764	4,748	16	.3	4,732	4,700	32	.7	4,700	4,700	0	
Married couple with 2 dependents:												
$3,650 [9]	0	0	0		0	0	0		0	0	0	
$3,750 [6]	15	0	15	100.0	0	0	0		0	0	0	
$3,800 [10]	22	7	15	68.2	0	0	0		0	0	0	
$4,000 [7]	52	35	17	32.7	28	0	28	100.0	0	0	0	
$4,300 [8]	97	77	20	20.6	70	0	70	100.0	42	0	42	100.0
$5,000	206	178	28	13.6	170	98	72	42.4	140	98	42	30.0
$7,500	607	578	29	4.8	561	484	77	13.7	514	484	30	5.8
$10,000	1,019	1,000	19	1.9	962	905	57	5.9	905	905	0	
$12,500	1,468	1,446	22	1.5	1,371	1,309	62	4.5	1,309	1,309	0	
$15,000	2,018	1,996	22	1.1	1,864	1,820	44	2.4	1,820	1,820	0	
$17,500	2,548	2,523	25	1.0	2,435	2,385	50	2.1	2,385	2,385	0	
$20,000	3,110	3,085	25	.8	3,060	3,010	50	1.6	3,101	3,010	0	
$25,000	4,352	4,324	28	.6	4,296	4,240	56	1.3	4,240	4,240	0	

[1] These burdens have been computed without use of the optional tax table.

[2] Eliminates the phaseout from the minimum standard deduction and increases the exemption from $650 to $675.

[3] Advances 1973's 15 percent standard deduction and $750 exemption to 1972 and increases the minimum standard deduction from $1,000 to $1,300.

[4] Increases the minimum standard deduction from $1,000 to $1,300.

[5] Highest level at which there is no tax in 1971 and 1972 under prior law.

[6] Highest level at which there is no tax in 1971 under the Revenue Act of 1971.

[7] Highest level at which there is no tax in 1973 under prior law.

[8] Highest level at which there is no tax in 1972 and 1973 under the Revenue Act of 1971.

[9] Highest level at which there is no tax in 1971 under prior law.

[10] Highest level at which there is no tax in 1972 under prior law

TABLE 10.—FEDERAL INDIVIDUAL INCOME TAX BURDEN [1] UNDER PRIOR LAW AND UNDER THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178), TAX LIABILITY, CALENDAR YEARS 1971, 1972, AND 1973 AND THEREAFTER

[Assuming deductible personal expenses of 18 percent of income]

Adjusted gross income (wages and salaries)	1971				1972				1973 and thereafter			
	Prior law tax	Revenue Act of 1971 [2]			Prior law tax	Revenue Act of 1971 [3]			Prior law tax	Revenue Act of 1971 [4]		
		Tax	Tax decrease			Tax	Tax decrease			Tax	Tax decrease	
			Amount	Percent			Amount	Percent			Amount	Percent
Single person:												
$1,700 [5]	0	0	0		0	0	0		0	0	0	
$1,725 [6]	$4	0	$4	100.0	$4	0	$4	100.0	0	0	0	
$1,750 [7]	7	$4	3	42.9	7	0	7	100.0	0	0	0	
$2,050 [8]	52	46	6	11.5	49	0	49	100.0	$42	0	$42	100.0
$3,000	207	189	18	8.7	193	$133	55	28.5	185	$138	47	25.4
$3,500	296	272	24	8.1	276	217	59	21.4	268	217	51	19.0
$4,000	396	362	34	8.6	367	302	65	17.7	358	302	56	15.6
$5,000	586	552	34	5.8	557	491	66	11.8	548	491	57	10.4
$7,500	1,005	1,000	5	.5	995	984	11	1.1	984	984	0	
$10,000	1,482	1,476	6	.4	1,470	1,458	12	.8	1,458	1,458	0	
$12,500	1,990	1,984	6	.3	1,978	1,965	13	.7	1,965	1,965	0	
$15,000	2,536	2,529	7	.3	2,522	2,509	13	.5	2,509	2,509	0	
$17,500	3,123	3,116	7	.2	3,109	3,094	15	.5	3,094	3,094	0	
$20,000	3,753	3,745	8	.2	3,737	3,722	15	.4	3,772	3,722	0	
$25,000	5,176	5,167	9	.2	5,158	5,140	18	.3	5,140	5,140	0	

Married couple with no dependents:												
$2,350 [9]	0	0	0	----------	0	0	0	----------	0	0	0	----------
$2,400 [6, 10]	7	0	7	100.0	0	0	0	----------	0	0	0	----------
$2,500 [7]	22	14	8	36.4	14	0	14	100.0	0	0	0	----------
$2,800 [8]	67	56	11	16.4	56	0	56	100.0	42	0	42	100.0
$3,000	97	84	13	13.4	84	28	56	66.7	70	28	42	60.0
$3,500	174	155	19	10.9	155	98	57	36.8	140	98	42	30.0
$4,000	254	230	24	9.4	230	170	60	26.1	215	170	45	20.9
$5,000	418	386	32	7.7	386	322	64	16.6	370	322	48	13.0
$7,500	782	772	10	1.3	763	744	19	2.5	744	744	0	----------
$10,000	1,171	1,162	9	.8	1,152	1,133	19	1.6	1,133	1,133	0	----------
$12,500	1,589	1,578	11	.7	1,567	1,545	22	1.4	1,545	1,545	0	----------
$15,000	2,040	2,029	11	.5	2,018	1,996	22	1.1	1,996	1,996	0	----------
$17,500	2,523	2,510	13	.5	2,498	2,473	25	1.0	2,473	2,473	0	----------
$20,000	3,035	3,023	12	.4	3,010	2,985	25	.8	2,985	2,985	0	----------
$25,000	4,156	4,142	14	.3	4,128	4,100	28	.7	4,100	4,100	0	----------
Married couple with 2 dependents:												
$3,650 [9]	0	0	0	----------	0	0	0	----------	0	0	0	----------
$3,750 [6]	15	0	15	100.0	0	0	0	----------	0	0	0	----------
$3,800 [10]	22	7	15	68.2	0	0	0	----------	0	0	0	----------
$4,000 [7]	52	35	17	32.7	28	0	28	100.0	0	0	0	----------
$4,300 [8]	97	77	20	20.6	70	0	70	100.0	42	0	42	100.0
$5,000	206	178	28	13.6	170	98	72	42.4	140	98	42	30.0
$7,500	544	527	17	3.1	510	476	34	6.7	476	476	0	----------
$10,000	924	905	19	2.1	886	848	38	4.3	848	848	0	----------
$12,500	1,314	1,295	19	1.4	1,276	1,238	38	3.0	1,238	1,238	0	----------
$15,000	1,754	1,732	22	1.3	1,710	1,666	44	2.6	1,666	1,666	0	----------
$17,500	2,205	2,183	22	1.0	2,161	2,117	44	2.0	2,117	2,117	0	----------
$20,000	2,710	2,685	25	.9	2,660	2,610	50	1.9	2,610	2,610	0	----------
$25,000	3,792	3,764	28	.7	3,736	3,680	56	1.5	3,680	3,680	0	----------

1 These burdens have been computed without use of the optional tax table.

2 Eliminates the phaseout from the minimum standard deduction and increases the exemption from $650 to $675.

3 Advances 1973's 15 percent standard deduction and $750 exemption to 1972 and increases the minimum standard deduction from $1,000 to $1,300.

4 Increases the minimum standard deduction from $1,000 to $1,300.

5 Highest level at which there is no tax in 1971 and 1972 under prior law.

6 Highest level at which there is no tax in 1971 under the Revenue Act of 1971.

7 Highest level at which there is no tax in 1973 under prior law.

8 Highest level at which there is no tax in 1972 and 1973 under the Revenue Act of 1971.

9 Highest level at which there is no tax in 1971 under prior law.

10 Highest level at which there is no tax in 1972 under prior law.