[COMMITTEE PRINT]

DESCRIPTION OF TECHNICAL AMENDMENTS TO THE TAX REFORM ACT OF 1976 (H.R. 6715) AND EXTENSIONS OF CERTAIN TAX PROVISIONS (H.R. 9251)

Prepared for the Use of the

COMMITTEE ON FINANCE

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INTRODUCTION

This pamphlet describes two separate bills which have been passed by the House of Representatives.

The first part of the pamphlet describes the technical amendments made by H.R. 6715, The Technical Corrections Act of 1977.[1] This bill was originally drafted by the staff of the Joint Committee on Taxation based on a review of the Tax Reform Act of 1976 with the assistance of the staffs of the Treasury Department and the Internal Revenue Service. The staff review took into account comments on proposed amendments by various bar organizations, accounting societies and other groups.

H.R. 9251, The Tax Treatment Extension Act, contains five amendments relating to the effective dates of certain provisions which either are about to expire or are to be changed by provisions as part of the Tax Reform Act of 1976. In addition, the bill prohibits the Treasury Department from issuing final regulations relating to deductibility of commuting expenses and to the fringe benefits area prior to specified dates in 1978. These provisions are described in part II of this pamphlet.

[1] The bill makes numerous clerical amendments, which are not described in this pamphlet. They are, however, described in the Ways and Means Committee Report on the bill (Report No. 95-700).

I. DESCRIPTION OF PROVISIONS OF H.R. 6715

A. Amendments to Income Tax and Administrative Provisions

1. Retirement Income Credit for Public Retirees Under Age 65 (sec. 2(a) of the bill and sec. 37 of the Code)

The 1976 Act increased the maximum retirement income credit base to $2,500 ($3,750 for joint returns if each spouse is eligible for the credit), renamed the general provision the credit for the elderly, simplified the qualification requirements, and broadened the category of eligible individuals age 65 and over. Although the credit for public retirees under age 65 was also simplified and increased, most of the prior law provisions for public retirees under age 65 were retained.

Under the bill, the community property rules are disregarded in determining eligibility for the special retirement income credit and in computing the credit for public retirees under age 65 and their spouses who file joint returns. The bill also specifies that in order for a married couple to claim the credit the spouse under age 65 must be the individual who performed the services qualifying for the public retirement income. In addition, the bill makes it clear that the special retirement income credit for public retirees under age 65 applies only to the taxpayer who actually performed the services covered by a public retirement system and his or her spouse.

This provision will increase tax receipts by less than $1 million per year.

2. Amendments Relating to the Minimum Tax

a. Special rules for minimum tax in the case of subchapter S corporations and personal holding companies (sec. 2(b)(1) of the bill and secs. 57 and 58 of the Code)

Under the minimum tax provisions, electing small business corporations (subchapter S corporations) and personal holding companies generally determine their tax preferences in a manner similar to individuals. The 1976 Act added a new preference for individuals with adjusted itemized deductions, i.e., certain itemized deductions in excess of 60 percent of adjusted gross income.

The bill makes two technical changes to clarify the application of the minimum tax provision to subchapter S corporations and personal holding companies. The bill clarifies that the preference for adjusted itemized deductions (sec. 57(a)(1)) does not apply to subchapter S corporations and personal holding companies, since these corporations have no adjusted gross income from which to calculate this preference. In addition, the bill amends the minimum tax provisions to clarify that the capital gains preference (sec. 57(a)(9)) for a personal holding company is to be determined under the rules applicable to corporations rather than those applicable to individuals.

These provisions will reduce budget receipts by less than $1 million per year.

b. Exemption for controlled groups for purposes of the minimum tax (sec. 2(b)(2) of the bill and sec. 58 of the Code)

Under present law, in the case of a controlled group of corporations, the group's $10,000 amount used in computing the minimum tax exemption is allocated among the members of the group equally or according to a plan adopted by the members of the group.

The bill would require the allocation of the $10,000 exemption amount to each of the members of a controlled group in proportion to each member's regular tax deduction.

It is estimated that this provision will increase budget receipts by less than $1 million per year.

c. Minimum tax imposed on trusts and estates (secs. 2(b)(3), (4), and (5) of the bill and secs. 57 and 58 of the Code)

The 1976 Act created a new preference for adjusted itemized deductions to the extent they exceed 60% of adjusted gross income for purposes of the minimum tax. Generally, the Act includes charitable deductions that are included as itemized deductions of trusts and estates for purposes of determining if there are "excess" itemized deductions treated as a preference under the minimum tax.

The bill clarifies in several respects the treatment of trusts and estates under the minimum tax in the case of the preference for adjusted itemized deductions. First, the bill makes it clear that the concept of "adjusted gross income" applies to trusts and estates in basically the same manner as to individuals. Second, the bill clarifies that the personal exemption (under sec. 642(b)) is not taken into account in determining the adjusted itemized deductions. Third, the bill provides that the deduction for administration expenses and, in the case of estates, wholly charitable trusts, transfers in trust before January 1, 1976, and pooled income funds the deductions for charitable contributions are treated as deductions in determining adjusted gross income. The bill also provides the Internal Revenue Service with broader authority to allocate preferences between a trust or estate and its beneficiaries.

Finally, the bill provides that the deduction for estate taxes attributable to income in respect of a decedent is not taken into account in computing the preference for adjusted itemized deductions for individuals or for trusts and estates.

This provision will increase budget receipts by less than $1 million per year.

3. Exclusion For Disability Income (sec. 2(c) of the bill and sec. 105 of the Code)

Under present law, as amended by the Tax Reform Act of 1976, the exclusion for disability income (the "sick pay" exclusion) is limited to a maximum of $5,200 a year per taxpayer. The sick pay exclusion is phased out based on the adjusted gross income of the taxpayer in excess of $15,000. Married couples claiming the sick pay exclusion are required to file joint returns.

To eliminate any ambiguity, the bill modifies the sick pay exclusion to specify that the $5,200 maximum exclusion is to be applied separately to each spouse and that the $15,000 adjusted gross income limit is to be applied to their combined adjusted gross income.

This provision has no effect on budget receipts.

4. Net Operating Loss Carryback and Carryforward (sec. 2(d) of the bill and sec. 172 of the Code)

Present law provides varying periods for the carryback and carryforward of net operating losses by different categories of taxpayers. For taxpayers in general, the law prior to the Tax Reform Act of 1976 allowed net operating losses to be carried back for 3 years and forward for 5 years. (A similar rule applied to insurance companies.) Regulated transportation companies were previously allowed to carry net operating losses back for 3 years and forward for 7 years.

The 1976 Act increased the loss carryforward period by two years for these categories of business taxpayers. The provisions of the 1976 Act, however, inadvertently also extended two additional carryover years to Banks for Cooperatives, which, like other financial institutions, were already allowed 10-year loss carryback and 5-year loss carryforward periods.

The bill corrects this oversight and eliminates Banks for Cooperatives from the categories of taxpayers which are eligible for the two additional loss carryforward years under the Tax Reform Act of 1976.

This provision has no effect on budget receipts.

5. Construction Period Interest and Taxes (sec. 2(e) of the bill and sec. 189 of the Code)

The 1976 Act added a new provision (sec. 189) requiring the capitalization and amortization of real property construction period interest and taxes by individuals, subchapter S corporations and personal holding companies. In the case of nonresidential real property, the new provisions apply where the construction period begins after December 31, 1975. However, no provision for an amortization deduction was provided with respect to construction beginning in 1976 where the taxpayer's taxable year began in 1975.

The bill clarifies that capitalization and amortization of construction period interest and taxes for nonresidential property is required only if the construction period begins on or after the first day of the first taxable year beginning after December 31, 1975.

It is estimated that enactment of this provision will reduce budget receipts in fiscal year 1978 by less than $1 million.

6. Tax Treatment of Certified Historic Structures (sec. 2(f) of the bill and secs. 167, 191, and 280B of the Code)

Under the 1976 Act, taxpayers are allowed to amortize over 5 years the expenses incurred in rehabilitating certified historic structures or, alternatively, to depreciate substantially rehabilitated historic structures using accelerated depreciation methods. The Act also prohibits deductions with respect to the demolition of certified historic structures and requires straightline depreciation on any replacement structure.

Under the Act, a certified historic structure is defined as a depreciable structure listed in the National Register, a depreciable structure located in a district listed in the National Register if the Secretary of the Interior certifies that the structure is of historic significance to the district, or a depreciable structure located in a State or locally designated historic district which meets certain tests.

The 1976 Act provides that the full amount of the rapid amortization deductions claimed are to be recaptured on the sale or exchange

of an historic structure (i.e., gain on the disposition, to the extent of the rapid amortization claimed, is treated as ordinary income rather than capital gain).

Under the definition contained in the 1976 Act, there is no requirement that State or locally designated districts satisfy the criteria for listing on the National Register or that structures be of historic significance to the districts. The bill conforms the definition with respect to structures located in State or locally designated districts with the rules applicable to Federally designated districts by providing that structures in these districts are certified historic structures only where the district substantially satisfies the criteria for listing in the National Register and the Secretary of the Interior certifies that the structure is of historic significance to the district.

The 1976 Act contains a special rule under which deductions are not allowed with respect to the demolition of a structure located in a registered historic district unless the Secretary of Interior certifies that the building is not of historic significance. The bill applies this special rule to structures located in State or locally designated districts. The bill also provides that, in order to obtain accelerated depreciation on a structure replacing a demolished structure which was located in a Federal, State, or locally designated historic district, certification that the structure to be demolished is not historically significant must be obtained prior to its demolition. (The provisions of the Act applicable to State and locally designated districts require straight line depreciation even if the replaced structure was not of historic significance).

The bill applies the real property recapture rules to rapid amortization deductions claimed with respect to rehabilitations of certified historic structures. Thus, recapture is limited to the excess of the amortization claimed over the otherwise allowable straight-line depreciation (computed on the basis of the actual useful life).

In addition, the bill clarifies other 1976 Act law provisions dealing with historic structures. Under the 1976 Act, a taxpayer could not elect rapid amortization and accelerated depreciation with respect to the same substantial rehabilitation of a certified historic structure. The bill makes it clear that taxpayers may not elect accelerated depreciation (under sec. 167(o)) on a substantially rehabilitated historic structure if they have previously elected rapid amortization of rehabilitation expenditures with respect to that building. The bill also makes it clear that the required use of straight-line depreciation with respect to a structure which has been substantially altered (other than by a certified rehabilitation) does not apply where there is a subsequent alteration of the structure which is a certified rehabilitation.

It is estimated that adoption of this amendment will reduce budget receipts by less than $2 million per year.

7. Deduction for Attending Foreign Conventions (sec. 2(g) of the bill and sec. 274(h) of the Code)

The 1976 Act provided new specific rules limiting the deduction for expenses of attending conventions, seminars or similar meetings held outside the United States, its possessions, and the Trust Territory of the Pacific. These rules apply not only to the individual attending the convention, but also to his employer, where the employer pays the expenses.

The bill provides that the limitations added by the Tax Reform Act of 1976 on the deductibility of attending foreign conventions do not apply to an employer (or other person) paying the expenses of an individual attending a foreign convention (either directly or through reimbursement) where that individual is required to include the expenses in his gross income. This exception would not apply in any case where the amounts paid are not furnished by the payor on information returns or statements required to be furnished to the payee (i.e., Form W–2 or Form 1099).

The 1976 Act also added a new provision which limits the deductibility of the full transportation expenses to and from the site of the convention to situations where "more than one-half" of the total days of the trip (exclusive of days travelling to and from the convention) are devoted to business activities. If "less than one-half" of the total days are devoted to business activities, the transportation expenses are allocated to business activities on the basis of the percentage of days devoted to business. No specific rule is prescribed when exactly one-half of the time is devoted to business.

To correct this situation, the bill makes it clear that a portion of the transportation expense will be denied only where less than one-half of the total days are devoted to business activities.

These provisions will have no effect on budget tax receipts.

8. Simultaneous Liquidation of Parent and Subsidiary Corporations (sec. 2(h) of the bill and sec. 337 of the Code)

Under present law, if a corporation adopts a plan of complete liquidation and within 12 months thereafter distributes to its shareholders all of its assets (less those retained to meet claims), gain or loss is generally not recognized to the corporation for tax purposes with respect to property it sold during the 12-month period (sec. 337).

The 1976 Act expanded this provision so that the rule for 12-month liquidations under section 337 is available for a sale by a member of an affiliated group of corporations if every other member of the group which receives a liquidating distribution also liquidates completely.

The bill makes the relief provided by the 1976 Act inapplicable where the parent (or common parent) is liquidated under the one-month liquidation rules of section 333. This provision will thus deny the benefit of section 337 where the corporation which sells assets is a first-tier subsidiary which then liquidates (under section 332) into its parent, after which the parent's shareholders liquidate that corporation under section 333.

In lieu of the reference to an affiliated group of corporations in the 1976 Act, the bill also substitutes references to the selling corporation and to distributee corporations which are members of a chain of includible corporations.

The definitions in the bill also deal with changes in stock ownership of the selling company (or of another company in the same chain) after the selling company adopts its plan or sells assets and before it begins making distributions in liquidation. If the selling company is a member of a chain of includible corporations at the time the selling company makes a liquidating distribution, each corporate member of the chain receiving a liquidating distribution at that time must itself liquidate completely.

It is estimated that adoption of this provision will reduce budget receipts by less than $1 million per year.

9. Transactions Involving Two or More Investment Companies (sec. 2(i) of the bill and sec. 368(a)(2)(F) of the Code)

Under present law, as amended by the 1976 Act, tax-free "reorganization" treatment is denied to investment companies ("swap funds") and their shareholders and security holders if such company (or companies) owns an undiversified portfolio of stock or securities before the exchange. Thus, under the swap fund rules, a realized loss can be created and deducted by a corporation or its shareholders and security holders where it results from an exchange among two or more "commonly-controlled" investment companies (if one of them has an undiversified portfolio), unless the corporate parties to the exchange are owned by substantially the same persons in the same proportions.

The bill disallows any loss resulting from an otherwise tax-free reorganization between one or more undiversified investment companies if more than 50 percent in value of the outstanding stock of the corporate parties to the exchange are owned, directly or indirectly, by or for the same individual.

In addition, the bill modifies the definition of an investment company to parallel the percentage requirements for portfolio diversification which are otherwise applicable to reorganization of two or more investment companies. The bill also adds the definition of the term "securities". Finally, the bill makes several changes in the language of the "reverse acquisition" rule in order to clarify the computation of the amount which shareholders will be deemed to realize in transactions to which this special rule applies.

It is estimated that adoption of this provision will increase budget receipts by less than $1 million per year.

10. At Risk Provisions (sec. 2(j) of the bill and sec. 465 of the Code)

The 1976 Act contained a special effective date provision for application of the at risk provision (sec. 465) to equipment leasing activities. Inadvertently, a cross-reference referred to a provision describing farming activities while it should have referred to leasing activities.

The bill amends subparagraph (A) of section 204(c)(3) of the Tax Reform Act of 1976, to refer to the special effective date provision for the application of the at risk provision to equipment leasing activities.

In addition, the at risk provision provides generally that the amount of any loss (otherwise allowable for the taxable year) which may be deducted in connection with any one of certain activities cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. The intent of the provision was to treat amounts disallowed by reason of the at risk provision in the prior taxable year in the same manner as amounts paid or accured from the activity to which section 465 applies in the current taxable year.

The bill amends the definition of loss for the taxable year (sec. 465(d)) to clarify that the deductions entering into the computation of loss for the taxable year include losses from prior years which, by virtue of section 465(a), are treated as deductions in the current year.

These provisions will have no effect on budget receipts.

11. Amendments Relating to the Use of Accrual Accounting for Farming (sec. 2(k) of the bill and secs. 447 and 464 of the Code)

a. Automatic ten-year adjustment period for farming corporations and partnerships required to use accrual accounting (sec. 2(k)(1) of the bill, sec. 447 of the Code)

The 1976 Act generally requires that certain farming corporations use an accrual method of accounting and capitalize preproductive period expenses. Exceptions are provided for subchapter S corporations, family corporations, certain small corporations, and taxpayers in the trade or business of operating a nursery. The Act also requires that certain farming partnerships (in which "nonexcepted" corporations are partners) use an accrual method of accounting and capitalize preproductive period expenses.

A transitional rule (sec. 447(f)) provided that a taxpayer who is required by this section to change its method of accounting can, except as otherwise provided in regulations, take the accounting adjustments required by this change into account over a ten-year period.

The bill states that a corporation or partnership which is required by section 447 to change to an accrual method of accounting with capitalization of preproductive period expenses is able to take the accounting adjustments required by such change into account over a 10-year period except in those situations where a corporation or partnership has a stated future life of less than 10 years. In cases where the corporation or partnership has a stated future life of less than 10 years, these adjustments may be taken into account ratably over its stated future life.

It is estimated that this provision will reduce budget receipts by less than $1 million per year.

b. Automatic 10-year adjustment for farming syndicates changing to accrual accounting (sec. 2(k)(2) of the bill, sec. 464 of the Code)

The 1976 Act provides limitations on certain types of deductions for farming syndicates. These limitations generally require farming syndicates (1) to defer deducting the cost of prepaid feed, seed, fertilizer, or other supplies until the supplies are used or consumed, (2) to capitalize or inventory certain preproductive period expenses of poultry, and (3) to capitalize preproductive period expenses of orchards and vineyards. No transitional rules were provided for farming syndicates affected by this provision.

The bill provides that, if a farming syndicate was in existence on December 31, 1975, and the syndicate elects to change to an accrual method of accounting with capitalization of preproductive period expenses, the net amount of the accounting adjustment required to be taken into account shall be spread over a period of 10 taxable years starting with the year of change (or ratably over the syndicate's remaining taxable years where the syndicate has a stated future life of less than 10 taxable years). This provision is to be available only if the farming syndicate changes to an accrual method of accounting with capitalization of the preproductive period expenses referred to in section 447(b). It is estimated that adoption of this provision will reduce budget receipts by less than $2 million per year.

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c. Extending family attribution to spouses in the farming syndicate rules (sec. 2(k)(3) of the bill, sec. 464 of the Code)

The 1976 Act limited certain types of deductions for farming syndicates. These limitations generally require farming syndicates (1) to defer deducting the cost of prepaid feed, seed, fertilizer or other supplies until the supplies are used or consumed, (2) to capitalize or inventory certain costs of poultry, and (3) to capitalize preproductive period expenses of orchards and vineyards.

In general, farming syndicates were defined to include (1) any partnership or other noncorporate enterprise engaged in farming if interests in the business were required to be registered with a Federal or State securities agency and (2) any partnership or other noncorporate enterprise engaged in farming if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs. Generally, limited entrepreneurs and limited partners are individuals who do not actively participate in management of the activity. Certain interests in farming enterprises are not treated as interests held by limited partners or limited entrepreneurs if the interests are attributable to active participation in farm management or certain other qualifications are met by an individual or certain family members of that individual. For purposes of this rule, a family is determined by reference to the grandparent of an individual, and family members are members of the grandparent's family. However, under the language of this provision, the individual's spouse and the spouses of other family members other than the grandparent are not included as family members.

12. Extensions of Certain Provisions to Foreign Personal Holding Companies (sec. 2(l) of the bill and secs. 189, 280, and 465 of the Code)

Present law

The 1976 Act contained a number of provisions to limit taxpayers' use of tax shelters.

All of these provisions apply to individuals, estates, trusts, subchapter S corporations and personal holding companies. These provisions do not apply to other corporations.

Since a foreign personal holding company can be utilized to shelter income from the individual income tax rates as well as domestic personal holding companies, the bill applies the 1976 Act tax shelter provisions to foreign personal holding companies.

This provision is expected to increase budget receipts by less than $2 million per year.

13. Definition of Condominium Management Association (sec. 2(m) of the bill and sec. 528 of the Code)

The Tax Reform Act of 1976 added a provision to the Internal Revenue Code (sec. 528) which permits certain homeowners associations to elect to be treated as tax-exempt with respect to their exempt function income. The homeowners associations which are eligible to make this election include condominium management associations and residential real estate management associations which satisfy certain statutory requirements. Under the 1976 Act, the definition of residen-

tial real estate management association requires that substantially all of the lots or buildings of the subdivision, development, or similar area which the association services "may only be used by individuals for residences" (sec. 528(c)(3)), but similar requirements for condominium management associations require that the units of the condominium project be "used as residences" (sec. 528(c)(2)).

The bill conforms the definitions of condominium management association with that of residential real estate management association by providing that all of the units of a condominium project be "used by individuals for residences." Thus, the bill makes it clear that no distinction was intended to be made between the two types of associations in this respect.

This provision has no effect on budget receipts.

14. Gain on Sale of Certain Property Transferred in Trust (sec. 2(n) of the bill and sec. 644 of the Code)

The 1976 Act added a new provision (sec. 644) which taxes a trust at the transferor's rate brackets where the trust disposes of an asset within 2 years of its transfer to the trust by the transferor. The statute applies to any gain *realized* by the trust, even if that gain would not be *recognized* by the trust under other provisions of the Code that provide for tax-free treatment in certain situations. Thus, for example, the new provision apparently would apply to stock exchanged in a tax-free reorganization of a corporation by the trust if the stock had been transferred to the trust less than 2 years before the reorganization.

The bill provides that the new rule applies only to gains recognized by the trust under the normal rules governing tax-free transactions. However, the bill provides that the new provision will apply to property received in a tax-free exchange to the same extent that it would have applied to the property given up in the tax-free exchange.

In addition, the application of the new provision is unclear where the transferor has items, such as charitable contributions, net operating losses, and capital losses, that are carried back or over from the transferor's taxable year in which the property was sold by the trust to another year.

The bill provides that the tax computation under the new provision is to be determined without regard to any loss or deduction which is carried (either back or forward) to another year of the transferor.

Also where the transferor incurs a net operating loss within three years after the year in which the transferred property was sold, the transferor may be permitted to carry back the net operating loss and thus reduce his taxable income for the year in which the transferred property was sold. In such a case, the trust would apparently be entitled to file a claim for refund since its tax under this new provision is based on the transferor's rate bracket.

The bill provides that the tax under the new provision is to be computed without regard to any net operating loss carrybacks to the transferor's taxable year which is used to determine the applicable tax rate. However, the tax is computed with regard to net operating loss carryovers from prior years and any net operating loss for the year of sale, to the extent no carryback or carryover arises from that year.

Generally, the new provision applies regardless of whether the trust elects to report income under the installment method for reporting

gain on a sale or exchange. However, the "includible gain" does not include any portion of an installment received by the trust after the death of the transferor.

Under the bill each installment is taxed at the grantor's tax rate if the installment sale occurred within the two year period after the transfer to the trust.

The bill also removes a conforming amendment in the capital gains throw-back rule which was repealed by the 1976 Act since the enactment of the new provision (sec. 644) removed the need for such a conforming amendment.

This provision will reduce budget receipts by less than $1 million per year.

15. Allowance of Foreign Tax Credit for Accumulation Distributions (sec. 2(o) of the bill and secs. 665 and 667 of the Code)

Distributions from trusts of previously accumulated income are taxed in substantially the same manner as if the income were distributed when earned. The 1976 Act makes several modifications in the manner in which accumulation distributions are taxed. These modifications leave unclear whether beneficiaries may claim the foreign tax credit with respect to foreign taxes paid by the trust which are allocable to accumulation distributions and, if a foreign tax credit is allowed, how it is computed. The bill provides rules under which beneficiaries may claim the foreign tax credit with respect to foreign taxes allocable to accumulation distributions so that the treatment of current and accumulation distributions are substantially similar in this regard.

In general, a beneficiary is allowed a credit against the additional tax imposed on an accumulation distribution for the taxes imposed on the trust allocable to the accumulated income distributed to him. The bill amends the definition of taxes imposed on the trust (sec. 665 (d)) by providing that, in the case of domestic trusts, this term includes foreign taxes as well as U.S. taxes which are allocable to the trust's accumulated income, with the result that the foreign taxes may be credited against the beneficiary's additional tax on the accumulation distribution.

A separate rule is provided under which the foreign tax credit is allowed with respect to accumulation distributions from foreign trusts. Under this rule, foreign taxes paid by a foreign trust which are allocable to accumulation distributions are generally treated as paid or accrued by the beneficiary in the taxable year for which the distribution is includible in his income.

This provision will reduce budget receipts by less than $1 million per year.

16. Source and Character of Accumulation Distributions from Trusts (sec. 2(p) of the bill and sec. 667 of the Code)

The 1976 Act substantially changed the treatment of distributions of income accumulated by trusts in years prior to the distribution. One of those changes is that distributions of previously accumulated income, other than those attributable to tax-exempt interest, do not retain in the hands of the beneficiary the character of the income from

which they were distributed. In the case of distributions of previously accumulated income to nonresident aliens and foreign corporate beneficiaries, the elimination of the characterization rules leaves unclear how to determine the amount, if any, of U.S. withholding tax to be imposed on the distribution.

The bill reinstates the rules that applied prior to the 1976 Act (under sec. 662(b)) with respect to accumulation distributions to nonresident aliens and foreign corporations. Thus, distributions by a trust of previously accumulated income made to nonresident aliens and foreign corporate beneficiaries will retain the character of the income from which the distributions are made.

This provision will reduce budget receipts by less than $1 million per year.

17. Limitation on Allowance of Partnership Losses in the Case of Nonrecourse Loans (sec. 2(q) of the bill and sec. 704(d) *of the Code)*

The Tax Reform Act of 1976 provided, in general, that for purposes of the limitation on allowance of partnership losses, the adjusted basis of a partner's interest is not to include any portion of any partnership liability with respect to which the partner has no personal liability. However, the rule does not apply to "any partnership the principal activity of which is investing in real property (other than mineral property)."

The bill clarifies a number of issues relating to the real estate exception by providing that, for a partnership to qualify under the real property exception substantially all of the activities of the partnership must relate to the holding of real property (other than mineral property) for sale or rental. The amendment also makes it clear that active as well as passive rental operations are within the exception to the new loss limitation of section 704(d).

This provision has no effect on budget receipts.

18. Exempt-Interest Dividend of Regulated Investment Companies (sec. 2(r) of the bill and sec. 851 of the Code)

A regulated investment company (commonly called a mutual fund) is permitted a deduction for dividends paid to its shareholders if it meets several tests. One of the tests is that at least 90 percent of its gross income must be derived from dividends, interest, and gains from the sale or other disposition of stock or securities. Another of the tests is that less than 30 percent of its gross income must be derived from the sale or other disposition of stock or securities held for less than 3 months.

The 1976 Act contained an amendment to the provisions dealing with regulated investment companies which permits a company to pay exempt-interest dividends to its shareholders if at least 50 percent of its assets are invested in tax-exempt State and local governmental obligations. However, interest on tax-exempt State and local governmental obligations is not included in gross income. Consequently, a regulated investment company investing all or most of its assets in tax-exempt obligations could fail to meet the 90- and 30-percent tests if, for example, it recognizes a relatively small amount of nonqualifying income.

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The bill provides that "gross income" for purposes of the 90- and 30-percent tests includes tax-exempt interest.

Also, a shareholder may invest in an open end tax-exempt mutual fund shortly before the record date of a future dividend and then tender his share for redemption immediately after the receipt of the tax-exempt interest dividend. Since the fund's assets have been depleted by the amount of the dividend, the shareholder will generally recognize a short-term capital loss on the redemption in the amount of the dividend. The net effect of the two transactions is to create an artificial short-term capital loss which can be used to shelter other capital gains of the shareholder. The bill disallows any loss recognized within 31 days of the date of purchase on shares in a tax-exempt mutual fund to the extent of any exempt interest dividend received by the shareholder.

This provision has no effect on budget receipts.

19. Real Estate Investment Trusts (sec. 2(s) of the bill and secs. 860, 856, 6501 and 859 of the Code)

The 1976 Tax Reform Act made extensive changes to the provisions relating to taxation of real estate investment trusts (REITs) and their shareholders. Under prior law, for example, a REIT could elect a fiscal year, and, if its shareholders used the calendar year for tax purposes, the shareholders could obtain a delay of up to two years in reporting income flowed through from the REIT. The 1976 Act provided that a REIT could not in the future adopt or change to any annual accounting period other than the calendar year.

Prior law also prohibited a REIT from holding property, other than property qualifying as foreclosure property, for sale to customers in the ordinary course of business. The 1976 Act permits REITs to hold such property; however, the net income from the sale of the property is taxed at a rate of 100 percent. In addition, gains derived from such property generally do not qualify for purposes of meeting the income source tests.

The bill amends the REIT taxable year provisions to require that any corporation, trust, or association which first qualifies for REIT status after October 4, 1976, must adopt or change to a calendar year in order to be eligible for REIT status. In addition, the bill clarifies the income source rules to require that, for purposes of the 75-percent income source test, qualifying income does not include gain from the sale of REIT shares which were held primarily for sale. The bill also corrects several erroneous or omitted cross references which relate to the REIT amendments in the 1976 Act.

This provision has no effect on budget receipts.

20. Amendments Relative to the Treatment of Foreign Income (sec. 2(t) of the bill)

a. Taxation of possessions corporations (secs. 2(t)(1) and (11) of the bill and secs. 901(g)(1) and 936 of the Code)

The 1976 Act restructures the taxation of U.S. corporations substantially all of whose operations are in Puerto Rico and the possessions ("possessions corporations"). In brief, the Act provides that possessions corporations are entitled to a tax credit equal to the U.S.

tax which otherwise would be paid on the income derived from the active conduct of a trade or business in a possession or from investments in the possession of the earnings from a possessions business.

A recent Tax Court case (*Kewanee Oil Co.*, 62 T.C. 728) has held that the sale of substantially all the assets of a trade or business does not, for purposes of the Western Hemisphere trade corporation provisions, constitute income derived from the active conduct of a trade or business. The 1976 Act does not specify the treatment of this type of sale for purposes of the possessions tax credit.

In addition, the 1976 Act denies the foreign tax credit for taxes imposed on distributions from possessions corporations to U.S. shareholders which are also partially or fully exempt from U.S. tax because of the dividends-received deduction or other nonrecognition provisions. However, the Act (sec. 901(g)) disallows the credit even where the distribution is fully subject to U.S. tax.

The bill makes it clear that taxable income from the sale of substantially all the assets which had been used by a possessions corporation in the active conduct of a possession business may qualify for the possessions tax credit. In addition, the bill provides that income from the sale or exchange by a possessions corporation of any asset generally will not qualify for the credit if the basis of the asset (for purposes of determining the gain on the sale or exchange) is determined in whole or in part by reference to its basis in the hands of another person (other than a possessions corporation).

The bill also provides that the denial of the foreign tax credit with respect to taxes imposed on distributions from possessions corporations does not apply to the extent that the distribution is fully taxable by the U.S. The bill also makes it clear that the disallowance of the credit also applies in the case of distribution from possessions corporations described in section 957(c) to the extent that income, gain, or loss is not recognized.

It is estimated that adoption of this provision will decrease budget receipts by less than $10 million in fiscal year 1978, and by less than $5 million annually thereafter.

b. Foreign tax credit adjustments for capital gains (secs. 2(t)(2) (A) and (B) and sec. (3) of the bill and sec. 904 of the Code)

The 1976 Act made several adjustments to the computation of the foreign tax credit to take account of the fact that capital gains are taxed differently from ordinary income. However, the Act applies those adjustments only for the computation of the limitation itself and not for other purposes.

In addition, the adjustments provided for in the 1976 Act in the amount of foreign capital losses taken into account in computing the numerator of the foreign tax credit limiting fraction does not apply to capital loss carryovers and carrybacks.

The bill provides that the adjustments with respect to capital gains and losses apply for all foreign tax credit limitation purposes so that the adjustments are applicable for loss recapture purposes. In addition, the bill amends clause (iii) of section 904(b)(2)(A) to make it clear that the three-eighths reduction provided with respect to foreign capital losses which offset U.S. source net capital gains is to be made

only in computing the numerator of the limiting fraction and to provide that the adjustment is also made where the foreign capital loss is a capital loss carried forward from a preceding year or carried back from a succeeding taxable year.

This provision has no effect on budget receipts.

c. Treatment of capital loss carryovers and carrybacks for recapture purposes (sec. 2(t)(4) of the bill and sec. 904 of the Code)

The 1976 Act provides that where a taxpayer has an overall foreign loss (or a foreign oil related loss) in one year, that loss is to be recaptured by recharacterizing foreign source income (or foreign oil related income) earned in future years as U.S. source income for foreign tax credit limitation purposes. An overall foreign loss is the amount by which foreign source income is exceeded by the deductions attributable thereto; a foreign oil related loss is the amount by which foreign oil related income is exceeded by deductions attributable thereto. Since foreign net operating losses carried to other years are included in the computation of the overall foreign loss or foreign oil related loss in the year sustained for recapture purposes, net operating loss carryovers or carrybacks are excluded from the computation of any overall foreign loss or foreign oil related loss for the year in which deducted in order to prevent a double counting of the loss. The Act similarly excludes capital loss carrybacks and carryovers from overall foreign loss and foreign oil related loss.

The bill amends the definition of overall foreign loss and foreign oil related loss to eliminate the exception for capital loss carryovers and carrybacks. Thus, such losses will be subject to recapture to the extent they are used as carryovers or carrybacks in years in which the taxpayer has an overall foreign loss or a foreign oil related loss.

It is estimated that this provision will increase budget receipts by less than $1 million per year.

d. Effective date of recapture of foreign oil related losses (sec. 2(t)(5) of the bill and sec. 904 of the Code)

The provisions requiring recapture of foreign oil related losses were added to the Code by the Tax Reduction Act of 1975. The provisions applied to losses sustained in taxable years ending after December 31, 1975. The 1976 Act modified the rules relating to recapture of foreign oil related losses and extended recapture to all foreign losses. The modifications to the foreign oil related loss recapture rules were intended to apply retroactively to the effective date of those rules under the Tax Reduction Act. However, the effective date of the 1976 Act modifications is taxable years *beginning* after December 31, 1975, rather than taxable years *ending* after December 31, 1975 (the effective date of the oil related loss recapture rules under the Tax Reduction Act).

The bill corrects this technical defect by providing that the modifications dealing with recapture of foreign oil related income made by the 1976 Act apply to taxable years ending after December 31, 1975.

This provision has no effect on budget receipts.

e. Transitional rule for recapture of foreign losses (sec. 2(t)(7)(A) of the bill and sec. 904(f) of the Code)

The 1976 Act requires that, in cases where a loss from foreign operations reduces U.S. tax on U.S. source income, the loss is to be recaptured by the United States if the company subsequently derives income from abroad. In general, the recapture is accomplished by treating a portion of foreign income which is subsequently derived as income from domestic sources.

The loss recapture provisions apply to losses sustained in taxable years beginning after December 31, 1975. An exception to the effective date was provided for certain cases where an investment in a substantially worthless corporation is continued beyond 1976 in an attempt to make the investment profitable, although the attempt may ultimately fail. The Act provides that in certain limited situations if the investment is terminated before January 1, 1979, there is to be no recapture of the loss to the extent there was on December 31, 1975, a deficit in earnings and profits.

The bill modifies the exception to the recapture rules for substantially worthless investments disposed of after 1976 and before 1979. Under the bill, in computing the December 31, 1975, deficit in earnings and profits, there is only to be taken into account earnings or deficits of years after 1962 and then only to the extent that the taxpayer owned the stock of the substantially worthless corporation in those years.

This provision will reduce budget receipts by less than $5 million over the next several years.

f. Transitional rule for recapture of possessions source losses (sec. 2(t)(7)(B) of the bill and sec. 1032 of the Act)

The 1976 Act repealed the per country foreign tax credit limitation for years beginning with 1976 and, in addition, provided that any foreign losses on an overall basis are to be recaptured out of future foreign income. However, the Act provided a three-year exception (i.e., up to 1979) to the repeal of the per-country limitation for income from sources within a possession of the United States (including Puerto Rico). In the conference relating to the Tax Reform Act of 1976, the conferees had agreed to adopt an exception to the loss recapture rules for losses arising in the possessions through 1978. However, the provision was inadvertently omitted from the conference report and the final legislation as enacted.

The provision creates an exception to the loss recapture rule for possession source income for taxpayers using the per-country limitation. Under the exception, losses from the possessions arising in years before 1979 would not be subject to recapture where those losses are attributable to a trade or business which was conducted in the possession before 1976. However, losses from possessions sources incurred during the pre-1979 transition period would nevertheless be subject to recapture in years after 1978 to the limited extent that affiliates of the taxpayer earn possessions source income during those years which is not included in the consolidated return (for example, income earned by an affiliated corporation making an election under sec. 936).

It is estimated that this provision will decrease budget receipts by approximately $2 million in fiscal year 1978. It is not likely to have any additional revenue effect until 1980, after which time there is some possibility that it could decrease budget receipts by up to $10 million.

g. Transitional per-country rules for certain mining companies (sec. (2)(t)(6) of the bill and sec. 904 of the Code)

Under the 1976 Act, the per-country limitation could be used by certain mining companies with respect to foreign mining income for a 3-year transitional period (taxable years beginning before January 1, 1979). The transitional rule provides also that any losses sustained by the mining companies would be recaptured on a per-country basis against income subsequently earned in the country where the loss was sustained. However, the transitional rule as drafted would require losses sustained by all qualifying mining companies during the 3-year transition period to be recaptured on a per-country basis even in those cases where, with respect to the year of the loss, the taxpayer elects to use the overall limitation rather than the transitional per-country limitation.

The bill amends the per-country transitional rule so that foreign mining losses sustained during the transition period will be recaptured on a per-country basis only if the transitional per-country limitation applied to the year in which the loss is sustained.

It is estimated that adoption of this provision will increase budget receipts by less than $1 million per year.

h. Limitation on credits for foreign taxes on oil and gas extraction income earned by individuals (sec. 2(t)(8) of the bill and sec. 907 of the Code)

The 1976 Act made several modifications with respect to the limitations on credits for foreign taxes paid on oil and gas extraction income. In the case of corporations, the limitation on extraction taxes was reduced to 48 percent, the maximum tax which the U.S. would impose on such income. However, in the case of noncorporate taxpayers, it was felt that the 48-percent limitation was not appropriate because foreign extraction taxes should be allowed as creditable taxes to the extent of the effective U.S. tax rate on the extraction income.

The change in the extraction limit in the case of noncorporate taxpayers was accomplished by eliminating the separate limitations for oil related income and the fixed percentage limitation on the extraction taxes of noncorporate tavpayers and by substituting a separate foreign tax credit limitation for foreign oil and gas extraction income. Thus, the limitation on extraction taxes paid by noncorporate taxpayers is an amount equal to the taxpayer's effective U.S. rate of tax (before foreign tax credit) times the taxpayer's foreign extraction income.

The bill retains as the limit on credits for extraction taxes paid by noncorporate taxpayers their pre-credit U.S. tax on extraction income, but it also conforms the treatment of extraction taxes for noncorporate taxpayers to the treatment afforded corporate taxpayers by imposing the separate limitation for foreign oil related income and limiting the excess credits which can be carried from a year to 2 percent of extraction income.

It is estimated that adoption of this provision will increase budget receipts by less than $5 million per year.

i. Foreign taxes attributable to section 911 exclusion (sec. 2(t)(10) of the bill and sec. 911 of the Code)

The 1976 Act made several modifications to the section 911 exclusion for earned income of U.S. citizens working abroad. (The Tax Reduction and Simplification Act of 1977 deferred the effective date of these provisions until taxable years beginning in 1977.) One of the 1976 Act modifications was to disallow as a credit or deduction those foreign taxes attributable to income which is excluded from U.S. tax.

The bill specifies the manner in which foreign taxes are to be determined attributable to excluded income and thus disallowed as foreign tax credits. The amount of foreign taxes disallowed is determined by multiplying the amount of the foreign taxes paid by a fraction the numerator of which is the U.S. tax on the excluded amount (plus the applicable zero bracket amount) and the denominator of which is the sum of the numerator plus the foreign tax credit limitation for the year. Under this method, taxes are generally disallowed in the proportion that the tax on the excluded amounts bears to the amount of U.S. tax which would be imposed on an amount of taxable income equal to foreign source income (thereby allocating foreign taxes between excluded and nonexcluded foreign source income in proportion to the U.S. progressive tax rate schedule). Where a taxpayer has U.S. source income, the amount of taxes disallowed is somewhat less because the average U.S. effective rate is applied to the nonexcluded foreign source income. However, this method greatly simplifies the calculation because it uses figures that are line items on the return which the taxpayer must compute in any event for other purposes.

This provision has no effect on budget receipts.

j. Gain on disposition of stock in a DISC (sec. 2(t)(12) of the bill and sec. 995 of the Code)

Prior to the 1976 Act, there was no recapture of accumulated DISC income (i.e., treatment as a dividend) on the distribution of DISC stock in certain tax-free transactions (sec. 311, 336, or 337) because no gain was recognized on the transfer. The accumulated DISC income would also escape recapture upon a subsequent disposition of the DISC stock by the distributee if the distributee did not carry over the distributing corporation's basis and holding period in the DISC stock (but instead received a stepped-up basis). Therefore, the 1976 Act requires recapture of the accumulated DISC income upon a distribution, sale, or exchange of DISC stock to which section 311, 336, or 337 of the Code applies. (Sec. 995(c)(1)(C).)

This recapture provision was not contained in the House version of the 1976 Act but was added to the Act as part of the Senate amendment to the DISC provisions, which generally were effective for sales after December 31, 1976. The conference committee adopted the substantive provisions of the Senate amendment, but with the December 31, 1975, effective date of the House bill. The use of the House bill's December 31, 1975, effective date results in the application of the Senate's recapture rule to transactions occurring during 1976 when the taxpayers did not have notice that the recapture provision would apply.

The bill makes the 1976 Act amendment inapplicable to those situations where the distributee of the DISC stock receives both a carryover basis and a tacked on holding period. Thus, for example, in a liquidation of a subsidiary to which section 334(b)(1) applies (in

which the basis and the holding period of property distributed by a subsidiary is carried over to its parent), recapture on the distribution of DISC stock would not be required.

The bill also delays the effective date of the DISC recapture provision of the 1976 Act until December 31, 1976.

It is estimated that this provision will reduce budget receipts by less than $1 million per year.

k. Limitation on partner's tax where partner is treated as having sold or exchanged section 1248 stock (sec. 2(t)(13) of the bill and sec. 751 of the Code)

The 1976 Act provides that if a partnership holds stock in a foreign corporation which would be subject to dividend treatment (under sec. 1248) if sold or exchanged, any gains to a partner receiving certain partnership distributions or selling his interest in the parnership will be treated as a dividend to the extent that he would have had a dividend had the foreign corporate stock been sold.

The dividend treatment rules on foreign corporate stock include a specific limitation applicable to individuals (sec. 1248(b)). The provision in the 1976 Act applying the dividend treatment rules to the partnership area did not include this special limitation relating to individuals.

The bill modifies the 1976 Act provision to provide that, in the case of an individual, the tax attributable to the sec. 1248 amount is to be limited in the same manner as it would be limited (under sec. 1248(b)) had the stock in the foreign corporation been sold by the individual or partnership.

It is estimated that adoption of this provision will reduce budget receipts by less than $1 million per year.

l. Excise tax on transfers of appreciated assets to foreign entities (sec. 2(t)(14) of the bill and sec. 1491 of the Code)

An excise tax (sec. 1491) is imposed upon the transfer of certain appreciated property to foreign entities. The tax applies to citizens or residents of the United States and to domestic corporations, partnerships, and trusts. Under prior law, it did not apply to estates because the basis of assets transferred at death was "stepped-up" to their fair market value on the date of death (or alternative valuation date where applicable). The 1976 Act increased the excise tax and expanded the application of the tax to additional types of property. In addition, the Act provided a carryover basis for assets transferred at death.

The 1976 Act also provides that the excise tax imposed on transfers of property to foreign persons to avoid Federal income tax shall not apply to "a transfer to which section 367 applies". In these instances, the taxation of such transfers is governed by section 367. The exception created in the 1976 Act for transfers to which section 367 applies produces some possibility that specific transfers to which that section does not apply because the IRS has determined that no tax avoidance is involved will inadvertently be subjected to the excise tax.

The bill extends the excise tax on transfers of property to foreign entities to transfers made by estates subject to U.S. tax. In addition, it extends the tax to transfers of appreciated property by U.S. persons to foreign estates.

The bill also provides that the excise tax does not apply to "a transfer described in section 367." As a result of this amendment, transfers of property described in section 367, although excepted from its application under section 367(a)(2), will not be subject to the excise tax imposed under section 1491.

It is estimated that adoption of this provision will increase budget receipts by less than $1 million per year.

m. Income tax treatment of nonresident alien individuals who are married to citizens or residents of the United States (secs. 2(t) (15) and (16) of the bill and sec. 6013(g) of the Code)

The 1976 Act permits a nonresident alien individual who is married to a citizen or resident of the United States to file a joint return provided that both spouses elect to be taxed on their worldwide income. Section 6013(g)(1) provides, in part, that the nonresident alien individual in question "shall be treated as a resident of the United States for purposes of chapter 1 for all of such taxable year."

The bill provides that nonresident aliens will be treated as U.S. residents for purposes of chapters 5 and 24, as well as chapter 1. It is contemplated that nonresident aliens electing under section 6013(g) will be treated as resident aliens under the procedural and administrative provisions of Subtitle F where those provisions relate to the treatment of the taxpayer under chapter 1, 5, or 24. In addition, the bill provides that a refund will be allowed for any overpayment of tax attributable to withholding taxes imposed (under sec. 1441) on income of an electing nonresident alien for a year with respect to which the election applies.

In addition, the Act provides that the election to be treated as a resident will apply to any individual who, at the time an election was made, was a nonresident alien individual married to a citizen or resident of the United States. A literal reading of this provision results in a timing requirement that, at the time the election is made, one of the spouses must be a nonresident alien married to a U.S. citizen or resident.

The bill deletes the requirement that one spouse be a nonresident alien married to a U.S. citizen or resident at the time of the election and provides instead that it applies to nonresident aliens who, at the close of the taxable year with respect to which an election is made, are married to U.S. citizens or residents.

This provision has no effect on budget receipts.

n. Foreign tax credit for production-sharing contracts (sec. 2(t) (9) of the bill and sec. 1035(c) of the Tax Reform Act of 1976)

An IRS Revenue Ruling (Rev. Rul. 76–215) holds that a contractor operating under a production-sharing contract in Indonesia is not entitled to a foreign tax credit for payments made by the government-owned company to Indonesia which contractually satisfy the contractor's liability. The IRS announced that this ruling would only apply prospectively to credits claimed for taxes paid in taxable years beginning on or after June 30, 1976.

The 1976 Act provides that Revenue Ruling 76–215 is not to apply to most taxpapers for taxable years ending in 1977 to amounts paid

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to foreign governments and designated as taxes under production-sharing contracts entered into before April 8, 1976. The 1976 Act generally intended to delay the effect of the ruling for one year so that the companies would have additional time to renegotiate their production-sharing contracts with Indonesia. The Act does result in a one-year delay in the effective date of the ruling for taxpayers on a calendar year basis (for taxes paid with respect to 1977) and for taxpayers with fiscal years beginning on or after June 30 (for Indonesian taxes paid with respect to 1976). In the case of taxpapers with fiscal years begining before June 30, the Act does not delay the effective date of the ruling (to cover Indonesian taxes paid with respect to 1977).

The bill delays the effect of the revenue ruling until 1978 for all taxpayers (so that amounts paid by all taxpayers in 1977 would be creditable).

It is estimated that this provision would decrease budget receipts by $5 million in fiscal year 1978 only.

o. Source of income on liquidation of foreign corporation (sec. 2 (t)(2)(C) of the bill and sec. 904(b) of the Code)

Generally, the source of income derived from sale of personal property, including stock, is determined by the place of the sale. However, the 1976 Act provided as a general rule that gain on the sale or exchange of personal property outside the U.S. which is not subject to a foreign tax of at least 10 percent will not be considered foreign source income. That general rule does not apply in certain specified situations including, in the case of a sale by a corporation of stock in a second corporation, those where the stock is sold in a country in which the second corporation derived more than 50 percent of its gross income. The provision was intended to prevent taxpayers from maximizing the use of foreign tax credits by arranging for sales of personal property to take place in low tax foreign countries.

The 1976 Act provision applies to liquidations as well as to other types of exchanges. However, the potential for artificially arranging a sale in a low-tax country does not exist in the case of liquidations because under the normal source rules any gain from a liquidation has its source in the country of incorporation. The bill provides that the source of income received by a corporation on the liquidation of a foreign corporation will be treated as foreign source income in all cases except where the foreign corporation derived 50 percent or more of its gross income from U.S. sources for the 3-year period ending with the close of its taxable year immediately preceding the year in which the liquidation occurs.

It is estimated that adoption of this provision will decrease budget receipts by less than $5 million per year.

21. Holding Period of Commodity Futures Contracts (sec. 2(u) of the bill and sec. 1222 of the Code)

Under prior law, assets were required to be held for more than 6 months to be eligible for long-term capital gain treatment.

The 1976 Act increased the holding period for long-term capital gains to 9 months for 1977 and to 12 months for subsequent years. An exception was provided for commodities futures contracts, which continue to be eligible for the 6-month holding period.

The increase in the holding period to 9 and 12 months was a provision included in the House bill but not in the Senate version of the Act. The language of the House bill provided the exception for "future transactions in any commodity" although the legislative history clearly states that what was intended was "future transactions in any agricultural commodity." The omission of the word "agricultural" from the House bill could not have been corrected by the conference committee because the change was technically beyond the scope of the conference. Thus, the 1976 Act provides for a continuation of the six-month holding period for all commodities futures contracts.

The bill limits the application of the 6-month holding period exception to agricultural commodities futures contracts.

It is estimated that this amendment will result in an increase in fiscal year budget tax receipts of $2 million for 1978 and $8 million for each fiscal year thereafter.

22. Gain From Sales Between Related Persons (sec. 2(v) of the bill and sec. 1239(a) of the Code)

Under present law, gain from sales or exchanges between certain related persons is treated as ordinary income. The 1976 Act expanded the application of this provision (sec. 1239) to include sales or exchanges between commonly-controlled corporations and to determine stock ownership by reference to the attribution rules generally applicable to corporations and shareholders (sec. 318).

In making these changes, the 1976 Act inadvertently changed the description of the property subject to the provision from "property of the character which is subject to the allowance for depreciation provided in section 167" to property which is "subject to the allowance for depreciation provided in section 167."

The bill amends section 1239(a) of the Code by deleting the language "subject to the allowance for depreciation provided in section 167," and substituting the language "property of a character which is subject to the allowance for depreciation provided in section 167." No substantive change in the law is intended by this change in language.

This provision has no effect on budget receipts.

23. Recapture of Depreciation on Player Contracts (sec. 2(w) of the bill and sec. 1245 of the Code)

The 1976 Act provides special rules for the computation of the amount of recapture of depreciation in the case of player contracts. One of the limitations on the amount recaptured is determined by reference to the depreciation on player contracts involved in the transfer of a franchise as reduced by any recapture on a prior disposition of the contracts.

Since there could be no prior dispositions of player contracts involved in a current transfer, the provision allowing a reduction for amounts recaptured as ordinary income for a previous disposition can be repealed. The bill deletes the Code provision allowing for a reduction in the amount recaptured on the disposition of a franchise by the amount previously recaptured in a disposition of the contracts transferred.

This provision has no effect on budget receipts.

24. Treatment of Pensions and Annuities for Purposes of Maximum Tax on Personal Service Income (sec. 2(x) of the bill and sec. 1348 of the Code)

The Tax Reform Act of 1976 amended the 50-percent maximum tax on personal service income to provide, in part, that amounts received as a pension or annuity were treated as personal service income (subject to certain special exceptions). However, the Act did not specifically limit the application of the maximum tax to pensions or annuities which are connected with earning income from personal services.

The tax bill clarifies present law by providing that the 50 percent maximum tax applies to a pension or annuity only when the pension or annuity arises from a situation where personal services were rendered either as an employee or as a self-employed person (such as an independent contractor).

The provision is expected to increase budget receipts by less than $1 million per year.

25. Certain Grantor Trusts Treated as Permitted Shareholders of Subchapter S Corporations (sec. 2(u) of the bill and sec. 1371 of the Code)

Prior to the 1976 Act, a corporation could not elect to be treated as a subchapter S corporation if it had a trust as a shareholder. However, an estate was permitted to be a shareholder. Under the Tax Reform Act, a so-called "grantor trust" is permitted to be a shareholder of a subchapter S corporation. In addition, the 1976 Act permitted a testamentary trust to be a shareholder in a subchapter S corporation for 60 days. However, the 60-day period was not extended to a grantor trust following the grantor's death although, in many cases, the trust is used as a will substitute.

The bill amends the qualification requirements for subchapter S treatment to permit a grantor trust to be an eligible shareholder for a two-year period following the grantor's death if the entire corpus of the trust is includible in the grantor's gross estate. If the entire corpus is not included in the grantor's gross estate, only 60 days are provided. The two-year period is roughly equivalent to the estate and trust period with respect to testimentary trusts, i.e., a normal period of administration while the stock is held by the estate and a 60-day period after the testamentary trust receives the stock from the estate.

The bill also makes it clear that a grantor trust is an eligible shareholder only if the grantor would be an eligible shareholder, i.e., is an individual citizen or resident of the United States.

This provision will reduce budget receipts by less than $1 million per year.

26. Tax on Excess Individual Retirement Plan Contributions (sec. 2(z) of the bill and sec. 4973(a) of the Code)

Under present law, deductible contributions by an individual for a taxable year to an Individual Retirement Account (IRA) are generally limited to the lesser of $1,500 or 15 percent of earned income. The 1976 Act increased the dollar limitation to $1,750 where contributions to the account are allocated equally between a spouse with earned income and a spouse with no earned income. If an amount in

excess of the deductible amount is contributed, the owner of the IRA is subject to a 6-percent nondeductible excise tax on the excess for the year of contribution and each later year for which the excess remains in the account. The 1976 Act also amended the excise tax provisions to provide that the tax on excess contributions would be imposed on the spouse to whom with IRA deduction is allowed (sec. 1501(b)(8)(A) of the Act and sec. 4973(a) of the Code). However, the deadwood provisions of the 1976 Act (sec. 1904(a)(22)) had the effect of repealing that amendment.

The bill provides for the imposition of the excise tax on the spouse who is allowed the deduction with respect to the contributions made to such account.

The provision has no effect on budget tax receipts.

27. Disclosure of Returns and Return Information (sec. 2(aa) of the bill and secs. 6103, 7213 and 7217 of the Code)

The 1976 Act significantly increased the confidentiality of returns and return information by restricting the instances in which returns or return information may be disclosed to those agencies and individuals enumerated in section 6103 of the Code.

Disclosure of mailing addresses to NIOSH (sec. 2(aa)(1) of the bill and sec. 6103(m)(3) of the Code)

The 1976 Act treats taxpayer return information, including the address supplied by the taxpayer on his or her income tax return, as confidential information not subject to disclosure by the IRS, except as specified in the Act. While the Act provides for disclosure of address information in certain situations, no provision was made in the Act for disclosure of that information to the National Institute for Occupational Safety and Health ("NIOSH") for any purpose.

The bill provides that, upon receipt of a written request, the Secretary will be authorized to disclose mailing addresses to officers and employees of NIOSH solely for the purposes of locating persons who, in their occupations, are, or may have been, exposed to a hazardous substance in order to determine the status of their health and to inform them of the possible need for medical care and treatment. This amendment is not intended to allow the disclosure of the mailing address of taxpayers for any other studies that have been or will be undertaken by NIOSH, except for the purposes stated above.

Disclosure of mailing addresses to the Commissioner of Education and educational institutions (sec. 2(aa)(1) of the bill and sec. 6103(m)(4) of the Code)

No exception was provided in the Act to permit the disclosure of the mailing address of persons who have defaulted on student loans. The bill provides that, upon the receipt of a written request, the Secretary will be authorized to disclose to the Commissioner of Education the mailing address of any taxpayer who has defaulted on a loan made from a student loan fund established under part E of title IV of the Higher Education Act of 1965 for use only to locate the taxpayer for purposes of collecting the loan. Any mailing address received by the Commissioner of Education under this provision may, in turn, be disclosed by the Commissioner of Education to any educational institution with which he has an agreement under part E of

title IV of the Higher Education Act of 1965. These addresses will only be disclosed to employees and agents of the educational institution whose duties relate to the collection of student loans and only for the purposes of locating and collecting the loans from the individuals who have defaulted on student loans made by the institution pursuant to this agreement. Any employee or agent of an educational institution receiving a taxpayer's address in regard to a defaulted student loan, who, in turn, makes a disclosure which is not authorized under section 6103, will be subject to the criminal penalties of section 7213.

Disclosure to State tax authorities of returns and return information regarding special fuel excise taxes (sec. 2(aa)(2) of the bill and sec. 6103(d) of the Code)

The 1976 Act provided that returns and return information relating to specified Federal taxes could generally be disclosed to State tax officials for the purpose of, but only to the extent necessary in, the administration of State tax laws. However, the 1976 Act omitted taxes imposed by chapter 31 of the Code (i.e., the special fuel excise taxes) from the list of taxes with respect to which information could be disclosed to State tax officials.

The bill includes returns and return information regarding the special fuel excise taxes imposed under chapter 31 of the Code among the returns and return information which the IRS is authorized to disclose to State tax officials.

Disclosure of name and mailing address to the Justice Department and other Federal agencies (secs. 2(aa) (3) and (4) of the bill and secs. 6103(i) (2) and (3) of the Code)

Under the 1976 Act, the Justice Department and other Federal agencies are required in nontax criminal cases to obtain court approval in order to receive return information which was filed by or on behalf of a taxpayer with the IRS. The court approval procedure, however, does not apply to return information which is not furnished by or on behalf of the taxpayer. Thus, in nontax criminal cases, the IRS may disclose to the Justice Department or other Federal agency return information, other than that furnished by or on behalf of the taxpayer, including return information which may constitute evidence of a violation of the Federal criminal laws.

The bill permits the IRS to transmit to the Justice Department and other Federal agencies the name and address of a taxpayer along with return information (including return information indicating the violation of a Federal criminal law) pertaining to, but not received from or on behalf of, the taxpayer.

Criminal penalty for unauthorized disclosure of returns and return information (secs. 2(aa) (5) of the bill and sec. 7213 of the Code)

Under the 1976 Act, the criminal violation of the disclosure rules is a felony punishable by a fine of up to $5,000, or imprisonment of up to 5 years, or both. It is also a felony, subject to the same penalties, for any person to receive an unauthorized disclosure of returns or return information as a result of an offer by that person to exchange an item of material value for the unauthorized disclosure.

The bill clarifies this section by explicitly providing that the criminal penalties of section 7213 are to apply only to willfully made dis-

closures, printings, publications, or solicitations, as the case may be. The term "willfully" relates to a voluntary, intentional violation of a known legal duty. See, *U.S.* v. *Pomponio*, 97 S. Ct. 22 (1976).

Civil penalties for unauthorized disclosures (sec. 2(aa) (6) of the bill and sec. 7217 of the Code)

The 1976 Act also provides that any person who knowingly or negligently discloses returns or return information in violation of the law is liable to the taxpayer for actual damages sustained plus court costs (but in no event less than $1,000 liquidated damages with respect to each unauthorized disclosure).

The bill amends the Code provision imposing civil penalties for knowing or negligent unauthorized disclosures of returns and return information (sec. 7217) to provide that no liability for this penalty shall arise in the event of an unauthorized disclosure which results from a good faith, but erroneous, interpretation of section 6103 and the rules and regulations relating thereto.

28. Definition of Income Tax Return Preparer and Negotiation of Taxpayer Refund Check by Banks (sec. 2(bb) of the bill and secs. 6695 and 7701 of the Code)

The Tax Reform Act of 1976 expressly exempts a fiduciary of a trust or an estate from certain rules relating to income tax return preparers for returns or claims for refund prepared for that trust or estate. However, other persons who prepare returns in a fiduciary capacity are not specifically excepted from the rules (for example, certain conservators or guardians whose fiduciary responsibilities are similar to those of trustees or executors).

The bill creates an exception from the tax return preparer provisions for any individual (and any employer of an individual) who prepares as a fiduciary a return or claim for refund for a person. The exception is limited to those returns of individuals with respect to whom the preparer (and the employer) is a fiduciary and does not affect a tax return preparer's status with respect to returns of other individuals.

The 1976 Act also prohibited any tax return preparer from endorsing a refund check of any individual whose return he prepared (except for subsequent endorsements by banks). A $500 fine was provided for violation of this provision.

The bill permits banks (as defined in sec. 581 of the Code) to endorse and deposit a customer's tax refund check in full to the customer's account in any case where the customer's tax return was prepared by that bank without violation of the penalties relating to endorsements of taxpayers refund checks by tax return preparers.

This provision has no effect on budget receipts.

29. Declaratory Judgments—Revocation of Prior Determination (sec. 2(cc) of the bill and secs. 7428 and 7476 of the Code)

In the 1974 pension Act (ERISA), Congress provided for declaratory judgments "in a case of actual controversy involving—(1) a determination by the Secretary with respect to the initial qualification *or continuing qualification* of a retirement plan * * *." (Emphasis supplied.)

The 1976 Act provided for declaratory judgments "in a case of an actual controversy involving—(1) a determination by the Secretary—(A) with respect to the initial qualification *or continuing qualification of* an organization as an organization described in section 501(c)(3) * * *." (Emphasis supplied.) Both the House and Senate committee reports on the 1976 Act stated that this statutory language, in both Acts, is intended to grant jurisdiction in cases where the Internal Revenue Service has concluded that a previously qualified organization has lost its preferred tax status.

On October 6, 1976, the Tax Court published an opinion (*Sheppard & Myers Inc. v. Comm'r*, 67 T.C. 26) in which it held that the retirement plans declaratory judgment provisions do not apply to revocations of favorable determination letters. The Tax Court decision made no mention of the 1976 Act or of the committee reports on that Act.

The bill makes clear that the declaratory judgment provisions relating to the qualification of retirement plans and relating to the status and classification of charitable organizations are to apply for revocations of any IRS determination in these areas.

These provisions have no impact on budget receipts.

B. Technical and conforming amendments to estate and gift tax provisions

1. Application of "Fresh Start" Provisions to Section 306 Stock (sec. 3(a)(1) of the bill and sec. 306(a) of the Code)

Under present law, special rules are provided to prevent the "bail-out" of dividends as capital gains upon a sale or redemption of preferred stock distributed to shareholders. Under these rules, the amount realized from a sale or redemption of certain preferred stock, known as "section 306 stock," is treated as dividend income. Prior to enactment of the carryover basis provisions of the 1976 Act, the dividend income treatment of the stock was eliminated when it passed from a decedent since the basis of the stock was "stepped-up" to fair market value at death. However, under the carryover basis rules, dividend income treatment for the amount realized (to the extent of a ratable portion of the corporation's earnings and profits) will apply to sales or redemptions of the preferred stock by the estate or heirs of the distributee shareholder.

The Act also provided for a "fresh start" adjustment to the basis of property held on December 31, 1976. However, the "fresh start" provision for carryover basis purposes will provide little, if any, relief for section 306 stock issued before 1977.

Since the fresh start rule was intended to continue prior law for appreciation occurring before January 1, 1977, the amendment would make it clear that dividend income only includes amounts received by the shareholder in excess of the stock's adjusted basis, including the fresh start basis adjustment, for section 306 stock which is carryover basis property distributed before January 1, 1977.

This provision will result in a decrease in fiscal year 1978 budget receipts of less than $1 million, of $15 million in fiscal year 1979, and of $12 million in fiscal year 1982. The revenue loss of this provision declines thereafter until fiscal 1997, after which time there is no revenue effect.

2. Redemptions of Certain Preferred Stock To Pay Death Taxes (sec. 3(a)(2) of the bill and sec. 306(b) of the Code)

In certain cases, a distribution in redemption of stock to pay death taxes is treated as an amount realized from the sale or exchange of a capital asset rather than as dividend income. However, special rules are provided to prevent the "bail-out" of dividends as capital gains upon a sale or redemption of preferred stock distributed to shareholders known as "section 306 stock."

Under the carryover basis provisions added by the 1976 Act, this special rule applies to section 306 stock in the hands of the heirs of the distributee shareholder. As a result, it is presently unclear whether the provision extending capital gains treatment for redemptions to pay death taxes overrides the preferred stock bail-out provision in the case where section 306 stock is redeemed from the estate or heirs.

The bill provides that a redemption of section 306 stock is excepted from dividend treatment to the extent that the redemption meets the requirements for capital gains treatment with respect to redemptions to pay death taxes and funeral and administration expenses (sec. 303). Accordingly, a distribution in a qualifying redemption of such stock is to be treated as an amount realized from the sale or exchange of a capital asset.

It is estimated that this provision will reduce fiscal year budget receipts by less than $1 million in fiscal year 1979, by $2 million in fiscal year 1980, by $3 million in fiscal year 1981, and by $4 million in fiscal year 1982.

3. Deduction or Adjustment to Basis for Estate Tax on Appreciation (sec. 3(b) of the bill and sec. 691 of the Code)

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for Federal and State death taxes attributable to appreciation. This adjustment is designed to prevent the imposition of an income tax on the portion of the estate taxes attributable to appreciation. Similarly, when property has been sold before death but the gain is recognized by the heirs for income tax purposes, the death taxes attributable to the gain are allowable as a separate deduction in computing the taxable income of the heirs (rather than as an adjustment to the basis of the property sold).

However, when the heir is entitled to preferential long-term capital gain treatment, there may be a substantial disparity of treatment for income tax purposes between gains recognized by the heirs for property sold before death by the decedent and gains realized by the heirs upon a subsequent sale of inherited property. The potential disparity of treatment depends on whether the estate tax adjustment is made in the form of a basis adjustment or a separate deduction.

The bill would eliminate any disparity of treatment by having the deduction for estate taxes attributable to income realized by a decedent, but recognized by the heirs, taken into account for capital gain purposes in the same manner as an adjustment to basis would be taken into account.

This provision will increase budget receipts by less than $5 million per year.

4. Fresh Start Adjustment for Certain Carryover Basis Property (sec. 3(c)(1) of the bill and sec. 1023(m) of the Code)

Under the carryover basis provisions added by the 1976 Act, a "fresh start" adjustment to the basis of inherited assets is permitted to reflect fair market value on December 31, 1976. This adjustment was intended to exclude appreciation occurring before 1977 from the carryover basis rule. However, to apply this fresh start rule, it is necessary to determine the property's basis immediately before death in order to measure the amount of appreciation occurring during the entire period a decedent had held the property. With respect to tangible personal property, it is particularly difficult to ascertain the fresh start adjustment in many cases because the executor or heirs may not be able to determine the basis of the property or even the approximate date on which the decedent had purchased the property.

The bill provides a formula to determine a minimum basis which reflects the fresh start adjustment. Under this formula, it would only

be necessary to determine the value of the property at the decedent's death. The minimum basis would then be determined by discounting this value for an assumed rate of post-1976 appreciation. Under the formula, the post-1976 appreciation is assumed to accrue at approximately 8 percent a year.

This provision will result in a decrease in budget receipts of less than $5 million per year.

5. Treatment of Indebtedness Against Carryover Basis Property (sec. 3(c)(2) of the bill and sec. 1023(g) of the Code)

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for the Federal and State death taxes attributable to appreciation. Generally, the adjustment is made by apportioning the death taxes to individual items of property on the basis of the appreciation for that item as compared to the fair market value of all property included in the gross estate. In making this apportionment under present law, a nonrecourse debt against property is taken into account (1) as a reduction in the amount of appreciation in the particular property to which it applies and (2) as a reduction in the total fair market value of property of all property included in the gross estate. It has been argued that this rule may result in misallocating the death tax adjustment between property subject to a nonrecourse debt and other property.

The bill provides that nonrecourse debt is not to be taken into account as a reduction of either the appreciation of the property or the fair market value of the property includible in the gross estate for purposes of allocating the death tax adjustment between items of carryover basis property.

This provision will reduce budget receipts by less than $1 million per year.

6. Only One Fresh Start With Respect to Carryover Basis Property Held on December 31, 1976 (sec. 3(c)(3) of the bill and sec. 1023(h) of the Code)

Under the carryover basis provisions added by the 1976 Act, a question has been raised as to the number of times a "fresh-start" basis adjustment may be made to carryover basis property when it is successively devised, bequeathed, or transferred by interstate succession by two or more decedents. In these cases, it has been argued that successive fresh-start basis adjustments may be made with respect to the property because the property will continue to have a basis which reflects, in part, the basis of the property on December 31, 1976, in the hands of the first decedent.

The bill would make it clear that only one fresh start basis adjustment may be made with respect to any carryover basis property. The adjustment is to be made with respect to the first death-time transfer of the eligible property after 1976.

This provision has no effect upon budget receipts.

7. Holding Period for Carryover Basis Property (sec. 3(c)(4) of the bill and sec. 1223 of the Code)

Prior to enactment of the 1976 Act, a capital asset acquired or passing from a decedent was considered to have been held by the estate or heirs for the period required for long-term capital gains

treatment. A conforming change was not made to this provision when the carryover basis provision was enacted by the 1976 Act.

The bill provides that, notwithstanding a shorter actual combined holding period by the decedent, his estate, and the heir, a capital asset which is carryover basis property is to be considered to have been held by the estate or heir for the applicable period required for long-term capital gains treatment.

This provision will decrease budget receipts by less than $1 million per year.

8. Adjustment to Carryover Basis Property for State Estate Taxes (sec. 3(c)(5) of the bill and sec. 1023(c) of the Code)

Under the carryover basis provisions as added by the 1976 Act, an adjustments to basis is permitted for Federal and State death taxes attributable to appreciation. With respect to State estate taxes, the adjustment is made to property subject to tax for Federal estate tax purposes. However, where the inclusion rules for State and Federal estate tax purposes are different, the present rule does not properly state how the basis adjustment for State estate taxes would be made.

The bill would modify the rule so that the basis adjustment for State estate taxes is to be made in reference to the estate tax inclusion rules under the applicable State law.

This provision will decrease budget receipts by less than $1 million per year.

9. Clarification of Increase in Basis for Certain State Succession Taxes (sec. 3(c)(6) of the bill and sec. 1023(e) of the Code)

Under the carryover basis provisions as added by the 1976 Act, an adjustment to basis is permitted for State death taxes attributable to appreciation that are paid by the heir and for which the estate is not liable (sec. 1023(e)). This adjustment was intended to apply to State inheritance and succession taxes actually paid by an heir. However, under most State laws, the estate is technically liable for the payment of these taxes and, as a result, it is somewhat unclear as to whether an adjustment would be permitted in such cases. The bill makes it clear that the adjustment will be available for State death taxes actually paid by an heir or trust for the benefit of heirs.

This provision has no effect upon budget receipts.

10. Coordination of Carryover Basis Adjustments (sec. 3(c)(7) of the bill and sec. 1023(h) of the Code)

Under the carryover basis provisions as added by the 1976 Act, adjustments to basis are permitted for (1) the so-called "fresh-start" adjustment to reflect fair market value at December 31, 1976, (2) the Federal and State estate taxes attributable to appreciation, (3) a minimum basis of $60,000, and (4) State inheritance taxes paid by the heir. Under the order prescribed for making these adjustments, the fresh start adjustment would be made first. The fresh start adjustment would then affect the amount of the other adjustments since it would be taken into account in measuring the amount of appreciation for purposes of the death tax adjustments and in determining whether the basis of all properties was less than the $60,000 minimum basis. How-

ever, the fresh start adjustment is taken into account only for purposes of determining gain from the sale or other disposition of the property by the estate or heirs and cannot be used to generate a loss from the sale or other disposition of the property. Accordingly, it has been argued that recomputations of the death tax adjustments and the minimum basis adjustments for each item of property may be required every time any heir sells appreciated "fresh start" property.

The bill would make it clear that no recomputation of the basis is required for the death tax or minimum basis adjustments. Basically, the basis of "fresh start" property for loss purposes would be the same as for gain purposes except that it would not reflect the fresh start adjustment.

This provision has no effect upon budget receipts.

11. Basis for Certain Term Interests (sec. 3(c)(8) of the bill and sec. 1001(e) of the Code)

In determining the amount of gain or loss from the sale of a term interest (such as a life estate, term of years, or an income interest in a trust), the basis of property acquired or passing from a decedent or transferred by gift is not generally taken into account by the holder of the term interest. Rather, the basis is taken into account by the holder of the remainder interest. A conforming amendment was not made under the 1976 Act to apply this provision to carryover basis property.

The bill applies the basis rule for sales or other dispositions of term interests to carryover basis property.

This provision has no effect upon budget receipts.

12. Clarification of the Rules Relating to Special Use Valuation (sec. 3(d)(1) of the bill and sec. 2032A of the Code)

Under the 1976 Act, if certain conditions are met, "qualified real property" may be valued for estate tax purposes at its farm or business use value, rather than at its value based on "highest and best" use. To qualify for the special use valuation rule, several requirements must be satisfied. First, the real property must have been owned by the decedent (or a member of his family) and used for farm or business purposes for five of the eight years preceding the decedent's death. Second, a substantial portion of the adjusted gross estate must consist of qualified property, i.e., 50 percent must consist of real and personal property used in the business and 25 percent must consist of real property used in the business. Third, qualified property referred to in the preceding sentence must pass to members of the decedent's family (known as "qualified heirs"). Also, the decedent or a member of his family must have materially participated in the business in which the property is used for five of the eight years preceding the decedent's death.

If these requirements are satisfied, it is unclear whether the remaining farm or business property of the decedent may be valued under the special use valuation rules even if it passes to persons who are not qualified heirs.

The bill makes it clear that real property is eligible for special use valuation only to the extent that it passes to qualified heirs.

This provision will have no effect on budget receipts.

13. Use of Special Use Valuation Property to Satisfy Pecuniary Bequest (sec. 3(d)(2) of the bill and sec. 2032A of the Code)

Under present law, the distribution of property by an estate or trust in satisfaction of a right to receive a specific dollar amount (that is, a pecuniary bequest) is treated as a taxable transaction resulting in the recognition of gain or loss to the estate. Since the distribution is treated as a taxable transaction, the property is not considered to have been acquired from or passed from a decedent. Thus, property otherwise qualifying for farm valuation would not appear to qualify if it were distributed pursuant to a pecuniary bequest.

The bill provides that, under the special use valuation provision, property shall be considered to have been acquired from or to have passed from a decedent if it is acquired by any person from the estate in satisfaction of the right of the person to a pecuniary bequest.

This provision will have no effect on budget receipts.

14. Gain Recognized on Use of Special Use Valuation Property to Satisfy Pecuniary Bequest (sec. 3(d)(3) of the bill and sec. 1040 of the Code)

Under present law, the distribution of property by an estate or trust in satisfaction of a right to receive a specific dollar amount (that is, a pecuniary bequest), is treated as a taxable transaction resulting in the recognition of gain or loss to the estate.

Under the law prior to the 1976 Act, the amount of gain or loss recognized on a distribution in satisfaction of a pecuniary bequest was limited to post-death appreciation because the estate received a stepped-up basis for the property. As a conforming change under the carryover basis provisions added by the 1976 Act, the Act also provided that, where an estate distributes property in satisfaction of a pecuniary bequest, gain is recognized by the estate only to the extent of the appreciation occurring from the date of the decedent's death to the date of distribution.

The limitation on gain recognized by the estate was intended to provide substantially the same income tax treatment provided under prior law for a pecuniary bequest distribution. However, under the statute, the amount of post-death appreciation is considered to be the difference between the value of the property for estate tax purposes and its fair market value on the date of distribution. Thus, if the statute is literally applied where property is subject to special farm or other business use valuation, a portion of the pre-death appreciation will be included in the gain recognized by the estate because the gain would be the excess of the value at the time of distribution over the special use value used for estate tax purposes.

The bill makes it clear that where an estate or trust satisfies a pecuniary bequest with appreciated property which is subject to the special farm or other business use valuation for estate tax purposes, the gain recognized will include only appreciation occurring after the date of death.

This provision will have no significant effect on budget receipts.

15. Treatment of Community Property Under Special Use Valuation Provision (sec. 3(d)(4) of the bill and sec. 2032A of the Code)

Under present law it is unclear whether the special use valuation provision for qualified real property applies in the same manner to

property held as community property as it does to property held by the decedent as his individual property in a common law State.

The bill makes it clear that the special use valuation provision is to apply to community property in the same manner as property owned by the decedent in his individual capacity.

This provision will have no effect on budget receipts.

16. Substitution of Bond for Personal Liability of Qualified Heir for Recapture of Tax with Respect to Special Use Valuation Property (sec. 3(d)(5) of the bill and sec. 2032A of the Code)

Under the special use valuation provision added by the 1976 Act, the tax savings made possible from special farm or other business use valuation is recaptured (in whole or in part) if the property is transferred outside of the decedent's family, or is used for a nonqualified use, within 15 years after the decedent's death. Under this provision, the qualified heir is personally liable for the recapture tax imposed on his interest in the qualified real property and, in addition, a lien for the tax is imposed on the property.

The bill provides that the qualified heir may be discharged from personal liability if the heir furnishes a bond for the maximum amount of recapture tax which may be imposed with respect to his or her interest in the qualified real property.

This provision will have no effect on budget receipts.

17. Security Where Extended Payment Provisions are Elected (sec. 3(e) of the bill and sec. 6324A of the Code)

Under present law as amended by the 1976 Act, there are two provisions permitting extended payment of estate taxes (over 15- or 10-year periods) where a farm or closely held business constitutes a substantial portion of the decedent's estate. Prior to the 1976 Act, where extended payment was elected, the executor was generally personally liable for the deferred estate taxes unless he posted bond equal to double the amount of the unpaid tax.

The 1976 Act relieved the executor from personal liability for the unpaid tax where one of these extended payment provisions is elected. Instead, if elected, a lien attaches to real property and other assets with long useful lives until the deferred taxes are paid. The amount of the lien is equal to the deferred tax liability plus the total amount of interest which will be payable on the deferred taxes.

Generally, if the liability for the deferred taxes is accelerated, collection will ordinarily be made within a relatively short time. Thus, it has been argued that there would be adequate security for the deferred taxes without having a lien for the amount of interest which would be payable over the entire deferral period.

The bill provides that the amount of the lien is equal to the amount of the deferred taxes plus the aggregate amount of interest payable over the first 4 years of the deferral period.

This provision will have no effect on budget receipts.

18. Transfers Within Three Years of Death (sec. 3(f) of the bill and sec. 2035 of the Code)

Under the 1976 Act, transfers made by a decedent within three years of death are included in the decedent's gross estate without regard to whether gifts were actually made in contemplation of death. However, the 1976 Act provided an exception to the auto-

matic three-year inclusion rule for gifts excludable under the $3,000 annual gift tax exclusion. Under this exception, the legislative history indicated that the amount of gifts included in the gross estate is limited to the excess of the estate tax value over the amount excludable with respect to these gifts. It has been suggested that this rule will impose serious administrative burdens upon executors as it will be necessary to ascertain whether the decedent had made gifts during the 3-year period (even though no return was required), and, if so, the value of the gifts at the time of the donor's death.

The bill provides that the exception to the estate tax inclusion rule applies to gifts made to a donee where no gift tax return was required to be filed with respect to the gifts, e.g., gifts to a donee that do not exceed $3,000 in a calendar year. If the gifts are required to be shown on a gift tax return, the gifts made within three years of the decedent's death are required to be included in the decedent's gross estate. This exception does not apply with respect to the gift of a life insurance policy.

This provision will have no effect on budget receipts.

19. Coordination of Gift Tax Exclusion and Marital Deduction and Estate Tax Marital Deduction (secs. 3(g) (1) and (2) of the bill and secs. 2035 and 2056 of the Code)

Under present law, as amended by the 1976 Act, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first $100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal lifetime transfers in excess of $200,000.

In addition, where interspousal lifetime transfers are less than $200,-000, the allowable estate tax marital deduction is reduced (or "cut-down") by the excess of the gift tax marital deduction with respect to gifts made after 1976 over 50 percent of the value of such gifts. However, where the unlimited $100,000 gift tax marital deduction has been used up but the aggregate gifts to a spouse do not exceed $200,000, the present formula will reduce the estate tax marital deduction "cut-down" where subsequent gifts of $3,000 or less are made to a spouse during a year (which are excluded from tax and for which a gift tax return is not required) because the "cut-down" is reduced by one-half the value of such subsequent gifts. In addition, no exception to the restoration of the "cut-down" in the allowable estate tax marital deduction is made where an interspousal lifetime gift is brought back into the estate of the donor spouse by reason of section 2035 (relating to transfers within 3 years of death).

This provision of the bill amends the estate tax marital tax deduction in two respects. First, it excludes any gift not required to be included in a gift tax return from the computation of the estate tax marital deduction "cut-down" (under section 2056(c)(1)(B)). Second, it provides that the estate tax marital deduction will not be reduced on account of any gifts to the surviving spouse which were included in the decedent's estate solely by reason of section 2035.

This provision will have no effect on budget receipts.

20. Split Gifts Made Within Three Years of Death (sec. 3(h) of the bill and sec. 2001 of the Code)

Under the gift tax law, a spouse may consent to be treated as the donor of one-half of a gift made by the other spouse to a third party. This is referred to as "gift splitting." Under the 1976 Act, where the

donor spouse dies within 3 years of making a "split gift," the entire gift is included in the donor spouse's estate and any gift tax actually paid by the consenting spouse on the gift is allowed as a credit in determining the estate tax for the estate of the donor spouse. However, the transfer tax consequences to the consenting spouse are not reversed. For example, any unified credit used is not restored and the amount of aggregate taxable gifts for prior periods is not adjusted.

The bill would generally provide for the reversal of the transfer tax consequences of gift splitting to the estate of the consenting spouse if the gift is included in the gross estate of the donor spouse as a transfer made within three years of death.

This provision will have no effect on budget receipts.

21. Inclusion in Gross Estate of Stock Transferred by the Decedent Where the Decedent Retained Voting Rights (sec. 3(i) of the bill and sec. 2036(b) of the Code)

Under present law, the retention of certain powers or interests by a decedent in property transferred by the decedent during his lifetime results in the property being includible in his gross estate for estate tax purposes (sec. 2036). The 1976 Act extended this rule to the retention of voting rights in stock of any corporation which was transferred by the decedent during his lifetime even if the corporation was not a controlled corporation. This rule is often called the "anti-*Byrum*" rule because it was intended to overrule the result reached in that case by the U.S. Supreme Court.

It has been argued that it is inappropriate to apply the voting retention rule to stock in corporations which are not controlled by the decedent and his relatives. In addition, it has been suggested that the 1976 Act rule did not apply to certain indirect retentions of voting rights.

The bill makes two amendments to the rule contained in the 1976 Act. First, the bill restricts the rule to stock in corporations which are controlled by the decedent and his relatives. Second, the bill clarifies the rule under the 1976 Act that indirect transfers are subject to the rule.

This provision will reduce budget receipts by less than $1 million per year.

22. Estate Tax Exclusion for Certain Retirement Benefits (sec. 3(j)(1) of the bill and sec. 2039(d) of the Code)

Under present law as added by the 1976 Act, annuities paid from individual retirement accounts, individual retirement annuities, and individual retirement bonds are excluded from the decedent's gross estate. The Act is somewhat unclear whether this exclusion applies in the case where contributions were deductible under a spouse-covered individual retirement account (sec. 220).

The bill makes it clear that annuities paid from a spouse-covered individual retirement account qualify for the estate tax exclusion.

This provision will have no effect on budget receipts.

23. Annual Exclusion for Spouse's Interest in an Individual Retirement Account (sec. 3(j)(2) of the bill and sec. 2503 of the Code)

The 1976 Act added provisions under which special income tax treatment was provided with respect to an individual retirement ac-

count, annuity, or bond for the benefit of an individual and his spouse. However, it is unclear as to whether a contribution to the account for the benefit of the spouse would be considered a gift eligible for the gift tax $3,000 annual exclusion since an interest must be a present interest in property to be eligible for the exclusion.

The bill would make it clear that the contributions made for the benefit of a spouse under an individual retirement account are not considered to be gifts of a future interest and therefore are to be eligible for the annual exclusion.

This provision will have no effect on budget receipts.

24. Gift Tax Consequences From the Creation of a Joint Tenancy in Personal Property (sec. 3(k)(1) of the bill and sec. 2515A of the Code)

Under present law, the creation of a joint tenancy in personal property with rights of survivorship constitutes a gift to the extent that the contribution made by a tenant exceeds the tenant's retained interest in the property. A similar rule applies in the case of a joint tenancy created in real property without rights of survivorship between spouses. In the case of a joint tenancy in real estate with rights of survivorship between spouses, no gift tax is imposed unless the donor spouse elects to treat the creation as a gift. Prior to the 1976 Act, when an election was made, the amount of the donor spouse's retained interest in realty was determined by use of actuarial factors if, under applicable local law, neither joint tenant could unilaterally sever the joint tenancy.

The 1976 Act eliminated the need to use actuarial calculations in the case of the creation of a joint tenancy by the husband and wife in real property. Under the Act, the retained interest of each spouse is considered to be one-half the value of the property even if neither joint tenant can not unilaterally sever the joint tenancy. However, the rule eliminating the use of actuarial values did not apply to the creation of a joint tenancy between husband and wife in personal property.

The bill generally eliminates actuarial calculations in determining the amount of a gift with respect to the creation of a joint tenancy between husband and wife in personal property. However, actuarial calculations will continue to be required if the fair market value of the joint interest of the personal property cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses. Thus, for example, the amount of a gift would conutine to be determined actuarially in the case of a gift involving a joint and survivor annuity.

This provision will reduce budget receipts by less than $1 million per year.

25. Fractional Interest Rule for Certain Joint Tenancies (sec. 3(k)(2) of the bill and sec. 2040 of the Code)

Prior to the 1976 Act, the estate tax law provided that on the death of a joint tenant, the entire value of the property owned in joint tenancy was included in a decedent's gross estate except for the portion of the property which is attributable to the consideration furnished by the survivor.

The 1976 Act added a provision which provided that in the case of a "qualified joint interest" created after December 31, 1976, one-half

of the value of a joint interest would be included in an estate of the first tenant to die. A qualified joint interest is a joint tenancy between a decedent and his spouse created by one or both spouses, the creation of which in the case of personal property constituted a gift in whole or in part, or in the case of real property an election was made to treat the creation as a transfer of property. Although the 1976 Act made no change with respect to joint interests created before January 1, 1977, a taxpayer can get the benefit of the new fractional interest rule by severing an existing joint tenancy and re-creating it if the re-creation is subject to a gift tax.

The bill allows a donor spouse to have a pre-1977 joint tenancy to be treated as a "qualified joint interest" without formally serving the joint tenancy and then re-creating it. This treatment is to be available if the taxpayer elects to report a gift of the property in a gift tax return filed with respect to any calendar quarter in 1977, 1978 or 1979. A taxpayer making the election is to be treated as having made a gift at the close of calendar quarter for which the return is filed. The amount of the gift generally is to be equal to one-half of the appreciation attributable to the consideration furnished by the donor spouse at the time of the creation of the joint interest.

This provision will reduce budget receipts by less than $1 million per year

26. Orphans' Exclusion Where There is a Trust for Minor Children (sec. 3(l) of the bill and sec. 2057 of the Code)

The 1976 Act provided a limited deduction for estate tax purposes for amounts passing from the decedent to his orphaned children. In order to qualify for the deduction, the property passing to the orphaned child may not be a terminable interest (such as a life estate), except that the property is permitted to pass to a person other than the child's estate if the child dies before attaining age 21. Because of this rule, it is not possible under the 1976 Act to create a single trust for the benefit of a number of orphaned children as a group.

The bill provides that property passing to a "qualified minors' trust" will qualify for the orphan's exclusion. Basically, a qualified minors' trust is one which, initially, is entirely for the benefit of the decedent's minor orphaned children. Distributions to these orphaned children must be made on a pro rata basis or made under one or more ascertainable standards relating to the health, education, support, or maintenance of the orphaned children. At the death of an orphaned child, his share of the trust must either (1) remain in the trust for the benefit of other orphaned children, or (2) it must vest (as a distribution or separate share) in another person. When the youngest orphaned child attains age 23, all interests in the trust must be vested on a pro rata basis in the orphaned children living at that time.

This provision will decrease budget receipts by less than $1 million per year.

27. Disclaimers (sec. 3(m) of the bill and sec. 2518 of the Code)

Under the 1976 Act, in order for a disclaimer to be valid for purposes of estate, gift and generation-skipping transfer taxes so that the person disclaiming is not treated as having transferred the property, the disclaimed interest must pass to a person other than the person

making the disclaimer. To satisfy this requirement, the person making the disclaimer cannot have the authority to direct the transfer of the property to another person. It is presently unclear as to whether a disclaimer is valid for tax purposes where a surviving spouse refuses to accept all or a portion of an interest in property passing from the decedent and, as a result of that refusal, the property passes to a trust in which the spouse has an income interest.

The bill provides that, where a surviving spouse refuses to accept an interest in property, the disclaimer will be valid although the surviving spouse receives an income interest with respect to the property if the income interest does not result from any direction by the surviving spouse and the disclaimer is otherwise qualified.

This provision has no effect upon budget receipts.

28. Power for Purposes of the Tax on Generation Skipping Transfers (sec. 3(n)(1) of the bill and sec. 2613(e) of the Code)

Under the 1976 Act, a transfer tax was imposed on taxable distributions or taxable terminations of powers and interests in a generation-skipping trust. The term "power" means any power to alter or establish the beneficial employment of the corpus or income of the trust. However, there is an exception to this rule where the only power held is one to allocate the corpus or income to lineal descendents of the grantor of the trust who are members of generations younger than that of the individual holding the power.

This provision creates problems in cases where the grantor wishes to employ an independent individual trustee (that is, a non-family member who is not subject to family control). The same problems do not arise where a corporate trustee is used because the termination of a corporate interest does not trigger generation-skipping tax unless there is reason to look through the corporation to individual beneficiaries.

The bill provides that an individual independent trustee will not be treated as having a power in the trust if his only power or interest is the power to dispose of the trust corpus or income for a beneficiary or class of beneficiaries designated in the trust instrument. For purposes of these rules, an independent trustee is a person who (1) is not closely related to the grantor of the trustee or any beneficiary, or (2) is not an employee of a corporation where the grantor or beneficiaries are executives or have significant voting power.

This provision will have no effect on budget receipts.

29. Clarification of Rules in a Generation-Skipping Trust Where a Beneficiary Has More Than One Power of Interest (sec. 3(n)(2) of the bill and sec. 2613(b)(2) of the Code)

Under the 1976 Act, where a beneficiary has more than one interest or power in a generation-skipping trust, the generation-skipping tax is generally postponed until the termination of the last such interest or power. The bill clarifies that postponement of the tax will occur only where the several interests or powers held by the beneficiary are present interests or powers. Thus, where only one of the interests or powers is a present interest or power (and the other interest or power is merely a future interest or power), the tax will not be postponed on the termination of the present interest or power.

This provision will have no effect on budget receipts.

30. Alternate Valuation in Certain Cases Where There is a Taxable Termination at the Death of an Older-Generation Beneficiary (sec. 3(n)(3) of the bill and sec. 2602(d) of the Code)

Under present law, the alternate valuation date is to be available for generation-skipping trusts where the taxable termination occurs by reason of death. However, it appears that the alternate valuation treatment is not made available in certain limited circumstances where the generation-skipping tax is postponed because the trust property passes to an older generation beneficiary for life before passing to younger generation beneficiaries.

The bill corrects this technical oversight and permits use of the alternate valuation date in those cases.

This provision will have no effect on budget receipts.

31. Adjustment for Trust Accumulation Distribution Subject to Transfer Tax (sec. 3(o) of the bill and sec. 667 of the Code)

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for Federal estate taxes attributable to appreciation. This adjustment is designed to prevent the imposition of an income tax on the portion of the estate taxes attributable to appreciation. Similarly, when property has been sold before death but the gain is recognized by the heirs for income tax purposes, the death taxes attributable to the gain are allowable as a separate deduction in computing the taxable income of the heirs (rather than as an adjustment to the basis of the property sold). In addition, similar adjustments are also permitted with respect to generation-skipping taxes imposed under the 1976 Act. However, the 1976 Act did not provide for an adjustment having a similar effect for trust distributions of accumulated income with respect to which an estate tax or generation-skipping tax had been imposed.

The bill provides that the tax imposed on a beneficiary with respect to an accumulation distribution will take into account the estate tax or generation-skipping tax attributable to the accumulated income.

This provision has no effect upon budget receipts.

32. Reliance by an Executor on Information Furnished by the IRS Concerning the Decedent's Taxable Gifts Made After 1976 (sec. 3(p) of the bill and sec. 2204 of the Code)

The 1976 Act imposed a single unified progressive rate schedule on the basis of the cumulative lifetime and deathtime transfers. Under this system, the estate tax is dependent upon the lifetime transfers of the decedent. In addition, an executor must file an estate tax return where the gross estate exceeds $120,000 (increasing to $175,000 in the case of decedents dying after 1980) reduced by the taxable gifts made after 1976.

Thus, in order to compute the amount of estate tax for which the estate is liable, the executor must know the total amount of taxable gifts which had been made by the decedent after 1976. Although an executor can obtain copies of any tax return of the decedent, there is nothing in present law which relieves an executor from personal liability for any estate tax because of incorrect information contained in those returns or for gifts for which returns were not filed.

The bill relieves the executor from liability for additional estate taxes attributable to gifts not shown on a return if the executor, in

good faith, relied upon information furnished by the IRS concerning the taxable gifts made by the decedent after 1976. However, the executor is not relieved from liability for gifts made within three years of the decedent's death.

This amendment will have no effect on budget receipts.

33. Amendment of Governing Instruments to Meet Requirements for Gifts of Split Interest to Charity (sec. 3(q) of the bill and sec. 2055(e) of the Code)

The Tax Reform Act of 1969 imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., part charitable and part non-charitable). In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined at least annually).

Many persons have created instruments that do not comply with these new requirements. As a result, Congress provided, as early as 1974, that the governing instruments of trusts could be amended to meet the new rules within certain time limitations. However, it provided this relief only in the case of the charitable deduction for estate tax purposes and only for remainder interests passing to charity. No relief was provided for the charitable deduction for income or gift tax purposes or for "income" interests passing to charity for income, gift or estate tax purposes.

The bill permits amendment of the governing instruments of charitable lead trusts to be effective for purposes of the income, gift, and estate tax charitable deductions if the amendment is made (or judicial proceedings are begun) by December 31, 1977. Similarly, the bill permits amendment of the governing instruments of charitable remainder trusts to be effective for purposes of the income and gift tax charitable deductions if the amendment is made (or judicial proceedings are begun) by December 31, 1977.

This provision will reduce budget receipts in fiscal 1978 by $12 million and will have no effect upon budget receipts thereafter.

34. Public Indexing of Federal Tax Liens (sec. 3(r) of the bill and sec. 6323 of the Code)

Generally, a Federal tax lien takes priority (with certain relatively limited exceptions) over interests in the property subject to the lien which are held by purchasers, holders of a security interest, mechanic's lienors and judgment lien creditors if notice of the tax lien has been appropriately filed before such interests are acquired. The 1976 Act provided that a notice of a lien is not to be treated as meeting the filing requirements unless a public index of the lien is maintained at the district Internal Revenue Service office in which the property subject to the lien is situated.

The amendment repeals the Federal indexing requirement. A new indexing requirement for the Federal tax lien would apply at the local

level where the notices of tax lien are usually filed and would apply only with respect to real estate.

In the case of real property, the new indexing requirement is to apply only if two conditions are met. First, State law must require public indexing of a deed to be valid against a purchaser of the property who does not have actual notice or knowledge. Second, the appropriate office where notices of tax lien are filed must have an adequate system for indexing of Federal tax liens.

Where these conditions are satisfied, the priority of a tax lien against purchasers and other creditors will be determined by the reference to the time of indexing rather than the time of filing of the notice of tax lien. Purchasers and creditors, who acquire their interests in the property subject to a tax lien before the notice of tax lien has been indexed, will be protected against a previously filed tax lien.

These provisions are estimated to have no significant revenue effect.

35. Clerical Amendments (sec. 3(s) of the bill and secs. 1016, 2051, 6324B and 6698 of the Code)

Section 3(s) of the bill reflects a number of clerical amendments to the estate and gift tax provisions:

Amendment of sec. 6698. The 1976 Act added two new section 6694's. The section 6694 relating to failure to file information will respect to carryover basis property is redesignated as section 6698.

Amendment of sec. 2051. This provision deletes a reference to the estate tax exemption which was repealed by the 1976 Act.

Amendment of sec. 1016. The paragraph added by the 1976 Act as paragraph (23) of section 1016(a) is redesignated as paragraph (21).

Amendment of sec. 6324B. This provision corrects a reference in section 6324B to conform the term "qualified real property" to its definition in section 2032A.

II. DESCRIPTION OF PROVISIONS H.R. 9251

1. Commuting Expenses (sec. 2 of the bill, Rev. Rul. 76–453, and secs. 62, 162, and 262 of the Code)

In general, a taxpayer is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. This includes transportation expenses incurred in the pursuit of a trade or business. However, no deduction is allowed for personal, living or family expenses, including the cost of commuting to and from work.

On November 22, 1976, the IRS published Revenue Ruling 76–453 (1976–2 C.B. 86) which states that a taxpayer's transportation expenses incurred in traveling between the taxpayer's residence and place of work, even though temporary, will be nondeductible commuting expenses, regardless of the nature of the work performed, the distance traveled, the mode of transport or the degree of necessity. The ruling was originally effective for transportation costs paid or incurred after December 31, 1976. The Service three times postponed the effective date of this ruling, and on September 23, 1977, announced that the ruling was suspended indefinitely and that proposed regulations inviting public comment would be issued shortly.

The bill requires that the application of the Internal Revenue Code provisions relating to the treatment of transportation expenses paid or incurred after 1976 and before May 1, 1978, in traveling between a taxpayer's residence and place of work are to be made fully in accordance with the rules in effect prior to the issuance of Revenue Ruling 76–453 on November 22, 1976. The IRS may not issue any ruling or final regulation prior to May 1, 1978, changing the tax treatment of these transportation expenses paid or incurred prior to such date.

This provision will have no effect on budget receipts.

2. Employee Fringe Benefits (sec. 3 of the bill and sec. 61 of the Code)

Section 61 of the Internal Revenue Code defines gross income as including "all income from whatever source derived," and specifies that gross income includes "compensation for services." Some fringe benefits, such as the provision of health insurance by an employer for its employees, are expressly excluded from gross income by the Internal Revenue Code; others are excluded by legislation outside the Code; and yet other exclusions are based on judicial authority or on administrative practice. While many fringe benefits are excluded on a *de minimis* principle, i.e., accounting for the benefit would be unreasonable or administratively impractical, other items, such as some benefits paid in kind, are excluded due to a combination of valuation difficulties and widely held perceptions that the items do not constitute income.

The bill provides that the Internal Revenue Service is precluded from issuing final regulations, under section 61, which would govern

the income tax treatment of fringe benefits prior to July 1, 1978. While the bill would prevent the IRS from deviating from the present administration of the tax laws as they concern the taxation of fringe benefits as compensation, the bill would not prevent the IRS from continuing to study the question of the appropriate tax treatment of fringe benefits.

This provision will not affect estimated budget receipts since it, in effect, continues present administrative practice.

3. The Tax Treatment of Income Earned Abroad by U.S. Citizens in Private Employment (sec. 4 of the bill and sec. 911 of the Code)

The Tax Reform Act of 1976 made several changes in the taxation of individuals working abroad which were originally effective for taxable years beginning after December 31, 1975. The Tax Reduction and Simplification Act of 1977 delayed the effective date of the 1976 Act changes with respect to the taxation of income earned abroad for one year, or until 1977.

The application of the 1976 Act changes in the earned income exclusion to income earned by individuals abroad beginning on January 1, 1977, substantially increases the tax paid by many of these taxpayers. A number of proposals have been made to change the substance of the 1976 Act provisions to deal with the problems of extraordinary housing and other costs which exist in certain parts of the world.

The bill delays the effective date for the changes made by the 1976 Act to the taxation of individuals working abroad (i.e., the changes to the exclusion and the change allowing the foreign tax credit to individuals claiming the standard deduction) so that the changes do not apply until taxable years beginning after December 31, 1977. However, the provision permits those individuals who elect the foreign tax credit to obtain the benefits of the zero bracket amount if the individuals do not claim the earned income exclusion.

The one-year delay in the effective date will result in a decrease in budget receipts of $45 million for fiscal year 1978.[1]

4. Salary Reduction Plans, Cash and Deferred Profit-Sharing Plans, and Cafeteria Plans (sec. 5 of the bill and sec. 2006 of the Employee Retirement Income Security Act of 1974)

On December 6, 1972, the Internal Revenue Service issued proposed regulations which would have changed the tax treatment of employees under salary reduction plans, and which called into question the tax treatment of employees under cash and deferred profit-sharing plans

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[1] This figure is based on the estimate used for the purpose of the Tax Reform Act of 1976 and the Tax Reduction and Simplification Act of 1977. The same estimate plus subsequent collections data (reflecting withholding and declarations receipts) is reflected in the revenue estimate of the Second Concurrent Budget Resolution for fiscal year 1978. Since the adoption of the Second Resolution, the revenue impact of the 1976 Act changes has been reestimated (using more recent statistics) at $228 million. If the new estimate of the revenues gained from the 1976 Act changes had been known when the Second Concurrent Resolution was adopted, the revenue estimate for the Resolution would have been greater by nearly the full amount of the increased estimate. As a consequence, even with the new estimate of the 1976 Act changes, the *net* effect on Second Resolution revenues for FY 1978 of a further one-year postponement of the 1976 provisions is only slightly more than $45 million.

and so-called "cafeteria plans." The Employee Retirement Income Security Act of 1974 froze the tax treatment of these plans for two years, and the Tax Reform Act of 1976 extended the freeze until December 31, 1977.

Under the bill, the "freeze" on existing tax treatment of salary reduction plans, cash and deferred profit-sharing plans and "cafeteria" plans is extended until January 1, 1980.

This provision has no effect on revenues.

5. Special Limitations on Net Operating Loss Carryovers (sec. 8 of the bill and secs. 382 and 383 of the Code)

The 1976 Tax Reform Act extensively revised the technical provisions of the Code dealing with the carryover of net operating losses in cases of acquisitions of loss corporations. The limitations on loss carryover attributes apply to acquisitions made by purchases or through corporate reorganizations. The new provisions change the basic concepts underlying the rules by deleting business continuity requirements for purchases and establishing new continuity of ownership tests applicable to both purchases and reorganizations.

These new provisions currently apply to plans of reorganization adopted on or after January 1, 1978, and to sales or exchanges in taxable years beginning after June 30, 1978. However, a number of problems have been brought to the committee's attention which will require consideration of additional revision of the rules.

The bill delays the effective date of the changes made by the 1976 Act for two additional years. As extended, the provisions will not take effect until January 1, 1980, with respect to plans of reorganization adopted on or after that date, or until June 30, 1980, with respect to sales or exchanges in taxable years beginning after that date.

The 2-year delay in the effective date of the provision is estimated to reduce budget receipts by less than $5 million annually in fiscal years 1978, 1979, and 1980.

6. Application of Section 117 to Certain Education Programs of the Uniformed Services (sec. 6 of the bill) and Five-Year Amortization for Low income Rental Housing (sec. 7 of the bill and sec. 167(k) of the Code)

The bill contains an amendment extending the exclusion from gross income for amounts received under the Armed Forces Health Professions Program (or substantially similar programs) for 2 years, so that amounts received in 1977 through 1982 will be excluded from income by members enrolling in the program before 1979. In addition, the bill contains a 1-year extension through 1978 of the special 5-year depreciation rule for expenditures to rehabilitate low-income rental housing.

These amendments were also contained in H.R. 3387 which was passed by the Congress on October 27, 1977.